The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Published monthly; subscription $2.00 per annum in advance. Advertising rates sent on request.

The Editorial Committee will be pleased to receive contributions on subjects of interest. Papers which may not be deemed suitable will be returned, if desired.

AUSTIN H. CARR, Editor,
10 Adelaide Street East, Toronto

VOLUME XXXV, No. 3 SEPTEMBER, 1939 ISSUE No. 194

Editorial Comment

(Contributed)

International Accounting Congresses

In the course of his recent Presidential address at the annual meeting of the Institute of Chartered Accountants in England and Wales, Mr. C. J. G. Palmour who had headed the British delegation to the Berlin Congress in September 1938 confessed that his experience had been such as to lead him to the conclusion that the value of international accounting congresses was strictly limited. Some of the papers submitted at the Berlin conference were both interesting and instructive but others revealed their authors as somewhat lacking in appreciation of the subjects with which they dealt. Apart altogether from the rigidity and formality imposed by the language difficulty it would seem that an international accounting congress could serve a useful purpose only if and to the extent that the profession in the several countries represented had a common tradition and also what cannot be precisely defined but what might be called a common philosophy. That these conditions are not satisfied at the present day by a meeting on the scale of the Berlin congress is fairly obvious and we think nothing but good can come of recognition of the

fact. A further objection raised by Mr. Palmour was that the discussions which followed the papers consisted almost entirely of the reading of set speeches. "Stimulating debate," he said, "of a type which leads to the broadening of knowledge and vision is generally conspicuous by its absence."

Mr. Palmour thought that the English Institute would be doing service to the study of accountancy and the cause of the profession generally by holding a summer school to which might periodically be invited representatives of the other accountancy bodies in Great Britain and the Empire overseas. This suggestion is meritorious but we could wish that it had embraced representation of the United States (as it probably would do if it were developed) with whom the professional link, though marked by differences of historical evolution, is so strong. There have not, so far as we are aware, been any formal Canadian - United States conferences of accountants but informally many of the conferences held in either country are international affairs in the sense that representatives official and unofficial of one country are present at the meetings of the other. The quality of the papers and discussion at some of those conferences prompt the thought that the most powerful stimulus at the present day to study the method and meaning of accountancy resides in the United States and that if Canada had to choose between a Pan-American and a British Commonwealth congress she would most likely throw in her lot with the former.

Distribution of Losses in Corporate Reorganizations

During the period 1930 to 1937 rather more than one hundred and sixty Canadian public companies defaulted on interest payments on bonds aggregating half a billion dollars which represented almost a quarter of the total bond indebtedness of all Canadian companies as estimated by the Dominion Bureau of Statistics. Up to last year one hundred and eleven of these companies had completed the process of reorganizing their capital structures and writing down their assets in accordance with the present scale of earning power and values, while most of the remainder were operating under the supervision of bondholders' committees and in process of reorganization.

It is impossible to make any estimate of the total loss suffered by all classes of security holders in the defaulting companies because of lack of knowledge of the real investment made by the common shareholders. Some attempt however can be made to see how the holders of the various classes of senior securities, i.e. bonds and preferred shares, have fared in the reorganizations which have already been completed. Loss or gain on principal can be calculated by comparing the face value of the original security with the market value of any new security received in exchange; loss or gain of income can be calculated by accumulating unpaid interest or divided at the contractual rate from the date of default and comparing this accumulation with a similar accumulation of interest or dividends paid on the new securities since reorganization.

A study by this method as at 31st March 1938 of thirty six companies representing a fair sample of all those that had undergone one or more reorganizations during the period 1930 to 1937 yielded some interesting and, as it seems to us, orthodox results. Three classes only of senior securities were distinguished, viz., mortgage bonds, other bonds (including collateral trust bonds, general mortgage bonds and debentures) and preferred shares. The total principal and interest (or dividend) due on these securities was $560,000,000 and in the process of reorganization $385,000,000 was lost. Of this amount 29% was borne by mortgage bondholders, 30% by other bondholders and 41% by preferred shareholders, percentages which are not of significance without the further knowledge that the amounts of the three classes of securities involved were respectively 222, 159 and 179 million dollars and which then indicate merely that the companies under study financed predominantly by bond issues and not preferred share issues. More significant percentages are those showing the portion of the investment lost by each type of security holder and these are 51, 70 and 84 respectively. The owner of a mortgage bond thus apparently lost 51 per cent. of his principal and income for the period of default, the owner of other bonds lost 70 per cent. and the owner of a preferred share lost 84 per cent. Actually the method of calculation (involving a market valuation at the closing date) does not justify us in attaching any absolute value to the figures of loss. The only conclusion which can properly be drawn is

that the risk of the three types was roughly in the ratio of 50, 70 and 80, a conclusion which probably does no violence to the popular estimate of their relative worth.

The Paperboard Shipping Container Industry

The Commissioner reporting the results of his investigation into an alleged combine in the manufacture and sale of paperboard shipping containers and related products came to the conclusion that "it would be difficult to devise a more complete elimination of price competition in any industry than has been achieved . . . in connection with the manufacture and sale of shipping containers. Certainly nothing more complete in this respect has been the subject of investigation under the *Combines Investigation Act* since it was passed in 1923." It is probably this fact which makes the report so interesting to the general reader whatever may be his own opinion as to the legality of the procedures described or as to the balance of loss or gain to the community resulting from those procedures.

The report deals with the activities of two trade combinations, Container Materials Limited, which was formed in 1931, and Shipping Case Materials Manufacturers Association, which has been operating since 1935. The Commissioner found that the first of these instituted a schedule of fixed prices for the products of the corrugated box industry and developed a system of control so rigid as to prevent any possible deviation from the agreement by subscribing companies and so inclusive that in March of this year only one company—and that one very recently established—was not maintaining the fixed prices. The features of the control as described in the report deserve mention. They include a system of production quotas (without which the maintenance of fixed prices is notoriously difficult) under which each member subject to the quota arrangement is allotted a certain percentage of the total business, paying a penalty if he sells beyond his quota, or receiving cash compensation if he sells below; the fixing of the qualities of materials used and restrictions on the services that may be rendered (so as to preclude preferential treatment by means of improved quality or service at the agreed price); a system of audit and investigation under which each manufacturer permits authorized representa-

tives of the association to have "free access at any time to his plant, books and records of every kind;" and the creation by a system of deposits and fines of a fund now amounting to about one quarter million dollars which has been used when new competition has developed to offer financial and other inducements to the new companies to persuade them to conform to the price agreement.

The objective of the second trade association with which the report deals, Shipping Case Container Materials Limited, was found by the Commissioner to be the elimination of price competition in the raw materials used in the manufacture of paperboard containers principally testboard and strawboard. In this case the quota system was not used but in all other important respects the measures adopted to secure price control were the same as those of Container Materials Limited.

It is well known that in the United Kingdom collective arrangements and systems of self-government (dignified by the name of "reconstruction") have been authorized by Parliament in certain depressed industries which had become matters of public concern. An example of such systems is the National Federation of Iron and Steel Manufacturers which was recently defended before the American Iron and Steel Institute by the treasurer of the British Institute against criticisms contained in the memorandum of the Temporary National Economic Committee. The speaker claimed that "unity" in the industry had averted unnecessary expansion, facilitated the integration of processes and the interchange of raw and semi-finished material and withal had operated to the benefit of the consumers and the country. The Commissioner argued that the success claimed for state-authorized schemes of this kind cannot be advanced in justification of the control which a private trade combination may take to itself in the interests of its own members. And he has added that even in the case of trade controls operated under public authority the problem of protecting the public interest in the absence of price competition is being found to be an increasingly difficult one.

The report of the Commissioner was referred by the Minister of Labour at Ottawa to the Attorney-General of Ontario but the Ontario Government has declined to prosecute. It is understood that the Dominion Government intends in these circumstances itself to undertake court action

in order to determine whether or not the agreements entered into by members of the paperboard shipping container industry constitute a combine within the meaning of the Criminal Code of Canada.

The Newsprint Industry

Early this year the Federal Trade Commission of the United States reported the results of an investigation which it had made into an alleged price fixing combine in the Canadian newsprint industry. The report has not been published but it is supposed to have found an indication that "concerted action by Canadian manufacturers restrains freedom of competition in the United States newsprint market." It might be supposed that the matter would end here since resident Canadian manufacturers are presumably not subject to the laws of the United States and specifically the anti-trust laws. Rather surprisingly however the United States Department of Justice, to whom the Federal Trade Commission submitted its report, is carrying the matter a step further by instituting an enquiry before a federal grand jury and issuing subpoenas for the attendance of witnesses. So far this type of enquiry is restricted to the newsprint industry in the Pacific coast area.

It would seem to a layman to be quite improbable that the existence of a trade combine in Canada even though it were proved to exist would be made the subject of complaint in a court of the United States. Supposing however that this were possible the situation in regard to the newsprint industry would be considerably complicated — and perhaps enlivened — by the circumstance that the association of newsprint manufacturers in eastern Canada has received the sanction of the Quebec and Ontario governments. It enjoys, that is to say, a status comparable with that of certain of the depressed industries in Great Britain to which we made some reference above.

Freedom of Speech in the United States

The constitutional guarantee of the fundamental liberties of the subject which have their origin in the Anglo-Saxon common law was made effective once again by the last decision handed down by the Supreme Court of the United States before it adjourned

for the summer vacation. That decision declared unconstitutional on its face (as a violation of the Fourteenth Amendment) an ordinance of Jersey City which categorically forbade public meetings without a police permit. In giving judgment to this effect the Court emphasized once again however that the freedoms of religion, speech, press and assembly are relative, not absolute and that abuse of these rights may be forbidden by law—as has happened for example where they have been used to advocate a breach of criminal law, to incite disregard of court injunctions or to urge overthrow of government by violence.

The principle of the decision is to be found in the words of Justice Roberts: "They (the streets and parks) have immemorially been held in trust for the use of the public, and time out of mind have been used for purposes of assembly, communicating thoughts between citizens and discussing public questions. Such use of the streets and public places has, from ancient times, been a part of the privileges, immunities, rights and liberties of citizens. The privilege . . . to use the streets and parks for communication of views on national questions may be regulated in the interests of all; it is not absolute but relative, and must be exercised in subordination to the general comfort and convenience and in consonance with peace and good order; but it must not, in the guise of regulation, be abridged or denied."

A formal guarantee of liberty such as is contained in the constitution of the United States cannot of itself ensure the perpetuation of liberty since the constitution itself may be overwhelmed. It does however serve the very useful purpose of providing an effective focus or rallying ground for the protestation of public acts which threaten liberty but which in the absence of a constitutional guarantee fail to catch the popular imagination or excite popular resentment. It also serves to retard the action of the majority and so to ensure that any limitation of freedom reflects the considered opinion and not merely a passing whim of that majority.

THE ACCOUNTANT AND THE COMMUNITY*

By W. Norman Bubb, Incorporated Accountant,
London, England

THE NATURE of the services rendered by the accountant and the duties and responsibilities devolving upon him as a corollary of such services have undergone great changes during the last hundred years, such changes being much more marked in the last half-century. Formerly, trading was for the most part carried on by individuals or small groups of persons in partnership. The accountant's responsibility, therefore, when consulted or called upon to prepare profit and loss accounts and balance sheets, was practically confined to the individuals concerned. Even in those days, however, the presence of bank overdrafts and loans often called for accounts, and balance sheets were, therefore, liable to be shown to third parties. As, however, trade continued to expand and larger aggregations of capital were required, joint-stock companies came into being. In 1844 an Act was passed for the registration of joint-stock companies but the liability of members thereof remained unlimited. In 1855 the privilege of limited liability, which hitherto had been considered as being against public policy, was granted to companies, whilst in 1862 previous legislation was repealed and re-enacted in a consolidated form in the Companies Act of 1862. New Acts followed as circumstances required until in 1908 the various Acts relating to companies were repealed and re-enacted, and subsequently there were three more Companies Acts which were cited with the principal Act as "The Companies Acts, 1908 to 1917." In the year 1925 a Government Committee was appointed to consider questions relating to the amendment of company law in order to bring legislation into line with post-war requirements, and the recommendations of that Committee were embodied in the Companies Act, 1928. In the following year the Companies Act, 1929, was passed, consolidating the Companies Acts, 1908 to 1928, and certain other enactments connected with those Acts, the Act of

*This paper was read 20th July 1939 at the Incorporated Accountants' Conference held at Nottingham, England, and a copy has been kindly supplied to our Editorial Committee by the Society of Incorporated Accountants. Mr. Bubb is a Fellow of his Society and a member of the Council.

1929 becoming effective on November 1 of that year and remaining the law on the subject today. The rapid growth of limited liability companies, both public and private, during the last fifty years has wrought innumerable and far-reaching changes, both from the point of view of the community and of the professional accountant himself, and it is for this reason that I propose to deal in some detail with this aspect first.

The Accountant and the Company

The accountant (termed "the auditor" in relation to companies) may be regarded as the "buffer" between the community and the board of directors. He is usually elected on the recommendation of the board, but he is not their servant but the servant of the shareholders and, as such, his responsibility is no sinecure. From the birth of the company to its demise it is the duty of the accountant to safeguard the interests of investors who are not in a position, individually, to decide whether or not an investment is a good one and so are forced to rely more and more upon published accounts and reports.

Dealing first with the birth of a company, in its prospectus one usually finds printed in a conspicuous place the name of a well-known firm of Chartered or Incorporated Accountants and the presence of this name on the prospectus is regarded by the community as a guarantee of good faith. In addition certain portions of the prospectus and statutory report have to be certified by the accountant or auditor.

During the lifetime of the company it is necessary for a report of the auditors to be presented to the members once in every year and at intervals of not more than fifteen months, stating that they have examined the balance sheet and that, having received all the information and explanations they have required, they are of opinion that such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company.

There are also provisions that the balance sheet must contain a summary of the authorized capital, the issued capital, the liabilities and the assets, with particulars show-

ing the nature of the liabilities and assets, and how the values of the fixed assets have been arrived at.

The information required under this Act represents the statutory minimum that must be included in any balance sheet, but this minimum should not of necessity be also the maximum. Many companies give their shareholders much more information and, generally speaking, if a company has nothing to hide there is no reason why this should not be done. An auditor should recommend the giving of additional information for the benefit of the shareholders and the investing public.

In particular there is the question of subsidiary, subsubsidiary and associated companies. With the modern ramifications of the structure of public limited liability companies, it is rather surprising that the Companies Act, 1929, requires such a small amount of information to be given. In fact, particulars regarding the shareholdings, any outstanding balances, and a general statement of aggregate profits and losses and how such profits and losses have been treated in the accounts is all that has to be given, and this information need only refer to direct subsidiary companies. This is not helpful and the excellent example set by such a company as the Dunlop Rubber Co., Ltd., in sending its shareholders a consolidated balance sheet of all subsidiary and associated companies is to be recommended and it is to be hoped that this desirable practice may become more generally followed.

Let us consider the position which arises when the directors of a company desire the auditors to certify accounts in a certain form and they refuse to do so, and for this reason the directors seek a change of auditor. There are certain safeguards in this connection in that notice must be given to the retiring auditor and also to the shareholders when any change is contemplated. There is a further extension of this which, although not statutory, is professional etiquette, namely that when an auditor is nominated in the place of an existing auditor he should immediately get in touch with the latter in order to discover the reason for the change. A further safeguard for shareholders is the statutory right of the auditor to attend any general meeting of the company when the accounts are being discussed and to make any statement or explanation he may desire

regarding such accounts. This enables the community, as represented by the shareholders, to come in contact with the auditors of the company, although it will be appreciated that there might be many questions asked which it would not be politic for the auditor to answer without reference to the board.

The Accountant and the Investor

In addition to the actual shareholders in any company there is that vast body of investors who are continually desirous of finding outlets for their surplus funds, and here the accountant has a very definite and important function to fulfil. Unless accounts as presented show the true position investors may be misled. Evidence regarding the existence of secret reserves (released in times of slump in order that dividends may be maintained) has already come before the Courts on at least one occasion. It is the accountant's duty towards the community to see that any such extraordinary credits are revealed, as otherwise the investing public may be induced to purchase shares at an artificially high figure, as it would appear from the accounts that profits are being maintained when, in fact, this is not the case. In an address given earlier this year to the Incorporated Accountants' District Society of Sheffield on "Disclosure in Published Accounts," the editor of the *Financial News* stated that the information given should serve a threefold purpose of the investor, enabling him, firstly, to test the adequacy of each deduction; secondly, to compare increases and decreases in expenditure with changes in the volume of business; thirdly, to test the efficiency of the management. This statement seems to me to sum up the ideal situation and it should gain the support of the influential and the well-informed investor.

Having dealt with the birth and life of a company, the time may come when the company is ill and it becomes necessary for a receiver to be appointed for the debenture holders. Here the accountant is called in to safeguard the interests of the community where it is apparent that the security is in jeopardy. He in effect collects the assets on behalf of the debenture holders and it is his duty to see that the proceeds thereof are properly applied.

There are other provisions which apply when a company is not doing too well or when the shareholders suspect

that all is not well. Under Section 135 of the Companies Act provision is made for inspectors to be appointed by the Board of Trade and often reconstructions are effected on the recommendation of the accountant whose advice has been sought.

Finally, there may come the day when a company, finding itself unable to pay its debts, goes into liquidation and the accountant as a professional expert is called in to see that the assets are equitably divided between the interested parties.

In every phase of a company's life, therefore, it will be seen that the accountant protects the interests of the community and, as was mentioned earlier, acts as the "buffer" between the community and the board of directors. At the same time the profession has to be continually on its guard to see that burdens are not placed on its shoulders which it is no part of the duty of the accountant or auditor to bear. When shareholders are aggrieved they are apt sometimes to seek to cast the blame on the auditors, seemingly losing sight of the fact that the auditor is in no way responsible for the conduct of the business. As things are, I think we can justly claim that our profession has to accept responsibility more than is the case in any other profession. Moreover, it has not the protection or privilege enjoyed by some others. A solicitor, for example, is able to relieve himself of much responsibility by taking the opinion of counsel and so far as concerns the responsibility for such opinion it simply does not exist.

Friendly Societies

Closely allied with the accountant's relation to shareholders and the investing public is his position *vis-à-vis* friendly societies, where the Registrar recommends the appointment of a public auditor. Such societies are not stringently protected by legislation as limited companies so far as the information that must be revealed is concerned, and therefore the provision of a panel of fully qualified accountants as public auditors provides a safeguard for the many small investors who have sunk their hard-earned savings in friendly societies and similar organizations. In his capacity as public auditor of these societies the accountant is perhaps of particular service to the community, because I am sure it will be agreed that the fees are more or less nom-

inal in relation to the work involved. At the same time accountants are in this way assisting materially in various thrift movements regulated under the Friendly Societies Acts. The appointments of public auditors are made by the Treasury annually and maximum audit fees are fixed as a condition of appointment. From a circular letter issued to public auditors the following paragraphs are of interest and are quoted in confirmation of the views just expressed:—

> "Experience has shown that a large proportion of the annual returns of Friendly Societies audited by 'lay' auditors who possess no qualifications for audit work are unsatisfactory, and in many cases losses have been incurred in circumstances which could not have arisen had the most elementary precautions been taken by the auditors."
>
> "The Friendly Society Movement has behind it a great tradition of public service, which has been fostered by a spirit of mutual helpfulness, and it is largely manned by voluntary workers who are inspired by the highest motives although they may sometimes be ill-equipped for the work they undertake. The ratio of management expenses is usually very low and audit fees are reckoned in shillings rather than guineas—a mistaken idea of economy, if one may judge by results, but difficult to eradicate."

In addition to the work referred to on such audits practically every member of the accountancy profession is from time to time called upon to perform audits on behalf of hospitals and other charitable organizations either in an honorary capacity or at very nominal fees and, whilst members of the profession are usually only too willing to be of assistance in such cases, there will be no disputing the fact that the work undertaken is done more in the interests of the community than of the accountant himself; at all events, from a commercial point of view.

Tax Avoidance—The Accountant's Position

There is another aspect of the accountant's relation to the community, and that is in reference to taxation. This subject will doubtless be fully dealt with by Mr. Fox* so far

*This is a reference to a paper entitled "The Accountant and the Individual" which was given by Mr. W. H. Fox, F.S.A.A., on 21st July at the Nottingham Conference.

as the individual is concerned, and therefore I will only deal with it briefly. The revenue of the country is indeed an all-important subject today, and if there is tax evasion on the part of some, other taxpayers must suffer. In normal circumstances the accountant will agree the income-tax liability of a company or an individual and, because he has a greater knowledge of the Income Tax Acts and because he appreciates the implications of those Acts, the finally agreed assessment is a correct one. Here again, therefore, the accountant acts as a "buffer," this time between the taxpayer and the revenue authorities, in order to see that tax is properly levied in accordance with the Income Tax Acts.

When income tax was at 1s. in the £ or less—as some of us recollect—there was little need for schemes to be devised in order to avoid taxation, but today we find income tax, sur-tax and National Defence Contribution at such high levels that ingenious methods are continually being thought out. The accountant is often consulted regarding such schemes and his position is a difficult one. He has a duty not only to his client but also to the State, but provided any scheme is legal he should give honest advice in connection therewith, always, however, warning his client of the tendency in recent Finance Acts of making legislation dealing with tax evasion retrospective. The Income Tax Acts and Finance Acts have to be strictly interpreted, and the question of equity does not arise. Therefore if a client has found a loophole in the Act he is entitled to benefit therefrom in the same way that he must suffer from the effects of some clause that is considered obviously unfair to him but is the law.

In the current issue of *Accountancy* is published an instructive and interesting article on this subject—admittedly a somewhat contentious one. The article is from the pen of our Vice-President, Mr. Richard A. Witty. His personal view is that avoidance schemes are detrimental to the real interests and reputation of the accountancy profession. Whilst many will agree, there are others who do not take up quite the same position. They contend, and it has been so held, that a taxpayer is entitled so to arrange his affairs as to attract the least tax liability so long as in so doing he does nothing illegal. It will thus be seen that the accountant has indeed a difficult task to perform in much of his work, of which the foregoing is not the least.

Whilst I have been writing this Paper we have had A.P.D.* added to the list of taxes. What tomorrow has in store one cannot say, but critics of A.P.D. have already cast envious but mistaken eyes on the work which will fall to the lot of the profession.

National Service

The recent register of accountants compiled for the use of the Government in case of national emergency shows another side of the accountant's relation to the community. It is often said that in time of war the man behind the lines is as important as the man in the trenches, and in modern warfare the non-military lines of defence certainly have a most important part to play. Such a time is one of astronomical figures of expenditure, and were it not for the work that professional accountants have to do in the preparation and checking of costing accounts and the like such figures might be still more astronomical. The professional accountant in a "key" position is a safeguard to the community of the proper spending of the revenue of the country. This fact was apparently recognized when the profession of accountants was included in the original list of reserved occupations. Although the profession has been removed from the subsequent list this does not in any way detract from the importance of the accountant or imply any change in the official view, and the register of accountants that is at present being analyzed may well prove a vital link in national defence.

Unqualified Accountants and Advertising

Another aspect of the accountant's relation to the community not to be overlooked is the standard of the profession. Everyone practising a profession should have a certain standard of skill, the usual measure of such standard being the qualification obtained through professional examinations. Whilst it is still possible for an individual to practise as an accountant and auditor without any qualifications at all, the more reputable professional bodies demand a definitely high standard of skill, and those who have passed the examinations of these bodies and are entitled to call themselves by the particular designation attached thereto

*Armament Profits Duty.

give the community a feeling of confidence when they are employed to act professionally.

The position of unqualified accountants is, therefore, one of some considerable concern, for while they often lack the skill they have numerous advantages that are not shared by members of the more reputable professional bodies. To take one example, they are allowed to advertise, and in this way can bring before the community the name of their firm and promises of what they profess to be able to do, in a way not permissible to the qualified professional accountant, while the fees quoted by "free lance" accountants are usually much lower than those of qualified accountants.

Whilst, quite rightly, any kind of advertising by an accountant is to be deprecated, one wonders at times whether the profession is not suffering in upholding its prestige in this respect. It is not suggested for one moment that individuals should be allowed to advertise, but it is a question whether the time has not come, and indeed is not already overdue, when the profession itself should give more publicity to the various services rendered by members of the profession to the community. I have in mind in particular the fact that for some time now the banks individually, not even collectively, have advertised the various services that they render to the community, and some of their clients who have entrusted their income tax and other matters to a bank have probably done so without thought of the accountant; in my view because the one has advertised the services he renders and the other has not. Banks claim that in rendering certain services to their clients they are doing so at the request of clients who seek their help. I do not dispute it; it confirms my remarks. I am not criticizing the banks so much as I am our own profession—due, I know, to their dislike of any kind of advertising. Banking, however, is a profession too and, whilst I do not suggest that accountants should advertise, I do feel there can be no harm in the community being kept informed of the work in which the profession specializes. The President of the Board of Trade recently stated that if you had a good thing it should be well advertised. We can deliver the goods; why not follow this advice?

There are indeed many other services rendered by the accountant to the community; for example, the services rendered by accountants to municipal authorities and by

accountants employed in commercial firms, cost accountants and others, and, last but not least, the great value that many accountants render to limited companies in their capacity as directors and/or chairmen.

Public Work

The work I have mentioned up to the present may be regarded as the professional side of accountants' duties, but there are many who employ their talents at little or no remuneration for the benefit of the community at large. The profession has a number of representatives in the House of Commons and in this connection such members' professional training is invaluable. No one should go into politics for what they can get out of it but rather what they can give to the community, and in this connection the profession is no exception. It is true that a member of Parliament is remunerated for his services, but after election expenses, contributions to local associations, charities and the like are deducted he usually finds himself considerably out of pocket. For this reason and the lack of time available owing to his many professional duties few can afford to undertake this aspect of public life until they have established themselves, and in most cases this means that they have perhaps passed the first bloom of youth. Therefore many accountants find other outlets for their public spirit and it is for this reason that in borough and county councils there are to be found many qualified accountants taking an active and most valuable part in the work of local councils and their sub-committees. Here the cost—in money if not in time—to the individual is less and members of the profession should be encouraged to undertake such work.

Accountants are renowned for their modesty, but, even so, the outline I have given of some of their daily tasks in the interests of the community is sufficient to make them blush, and by the time that the second paper has been delivered tomorrow, I feel that they will be unable to avoid it, as Mr. Fox will be able to say as much as I have done, and probably more, to give proof of the equally valuable services the accountant renders to the individual. I think, however, I have said sufficient to prove that the professional accountant more than justifies his existence and fills such an important rôle in the world of commerce and business today that without us one wonders how the world could go on!

THE LEARNED JUDGES AND THE AUDITOR

A Synthesis In Interpretation of Jurisprudence Affecting Auditors

by Edward F. Jeal, B.Sc.(Econ.), A.C.A.

Editor's Note: The first instalment of an article published in *The Accountant*, (England), in its issues of 10th and 17th June 1939 and reprinted herein by kind permission of the Editor of *The Accountant*. The second will appear in our October issue.

1. Introduction*

The statutory position of an auditor derives from three distinct, but closely related, sources:

(*a*) The statute itself (the Companies Acts and certain other Acts), which is not made up of a series of edicts forming a sort of comprehensive or idealist scheme, but consists, so far as accounts and the audit thereof are concerned, of certain rules and of regulations for procedure;

(*b*) Case-law, i.e., judgments on specific matters which have come before the Courts as actions, in which the learned Judges have been called upon to interpret the statute in accordance with the general principles of English law considered in conjunction with precedent and with professional and commercial usage;

(*c*) Professional and commercial usage, i.e. the procedure followed, in the ordinary course, by practitioners, which has developed from the application, within the limits of convenience, of accounting theory to business affairs conducted by directors of companies.

Evidently, as time goes on, these factors show some tendency to react upon one another, and it is the second which has served as a sort of evolutionary link between the other two. This article consists of an endeavour to present the results of the deliberations in the Courts during the last half-century as a connected whole. Should there be passages in it which would appear inelegant to a trained experienced lawyer, the only apology which can be offered is that it has been written by an accountant for accountants, and not by a lawyer well versed in accountancy matters.

*The author much appreciates having been able to benefit from the opinions of Mr. Stanley W. Rowland, LL.B., F.C.A., who read the article in draft, making numerous comments thereon.

2. In What Circumstances May an Auditor Come Into Contact Officially With the Members of His Majesty's Bench of Justices?

Before proceeding to an interpretation of the judicial view on auditing—and, to some extent, on accounting—questions, it is preferable to summarize the circumstances which may give rise to the expression of the judicial view.

In the past, auditors have had to appear before Judges in three classes of proceedings, viz.:

(i) *Ordinary Civil Actions*—Where an action has been brought against an auditor, either under the general body of common law, or under provisions in the statutes calling for his appointment, by the members of the company, or any of them, with the intention of endeavouring to prove that the auditor has been guilty of a default which has caused material loss to the interests of the company; if the plaintiffs succeed in proving a default, they will be entitled to a judgment awarding damages.

The auditor will be apt to expose himself to an action where he has not qualified his report—in certain cases, however, remarks made by the directors in their annual report may cover him—if:

(*a*) He has not been able to verify an asset or liability or to satisfy himself generally as to the correctness of an item of income or expenditure. (It is, of course, to be understood that, as a general rule, a disclaimer by him in the event of insufficient verification will not protect him unless it has been, practically speaking, impossible for him, either personally or by an agent—preferably acting for him—to obtain the necessary assurances as to the correctness of the accounts.)

(*b*) In accordance with the canons of accounting and audit usage, the accounts contain an asset which is overvalued or a liability the amount of which is understated, so that the accounts presented to the members are not a fair representation in general terms of the financial position of the company.

(*c*) Transactions have occurred which were *ultra vires*: if the law has been broken, e.g. where a company has dealt in its own shares; if the company has exceeded its statutory powers, e.g. by exceeding the scope of activities permitted

to it by the "objects clause" of its memorandum of association, or if the directors have exceeded the borrowing powers instead of consulting the shareholders as provided by the company's articles of association.

(*d*) A fraud has occurred which, by the exercise of ordinary professional skill, he should have discovered.

(ii) *Actions brought for Misdemeanours, Misfeasances, etc., of Officers of Companies*—Where it is contended:

(*a*) After a company has gone into liquidation, that an auditor has, prior to the liquidation, committed a misdemeanour (e.g. has been involved in an inducement, by false pretences or other form of fraud, made to someone, to give credit to a company; or in the neglect to have kept proper books, etc., as defined by law; or in the falsifying or destroying of the books, etc.), and he will, if he be convicted, be imprisoned. Or that he has committed some act of a criminal nature (and in certain cases he will be liable in this event even if he is not in law an officer). Or that he has committed misfeasance, e.g. a breach of trust, which has caused material damage to the company which, if he is convicted, he will be made to compensate, notwithstanding that if the act is criminal, criminal punishment may also be applied to him. (Sections 274 and 276 of the Companies Act of 1929.)

(*b*) That he—whether he be in law an officer or not—has, in a statutory document, wilfully made, or wilfully concurred in the making of, a statement false in any material particular, knowing it to be false, he may be prosecuted for misdemeanour, and, if convicted, he will be imprisoned or fined. (Section 362 of the Companies Act of 1929.)

In connection with the above it is to be noted that it was decided in the *London General Bank, Ltd.* case in 1895, and confirmed in the *Kingston Cotton Mill Co., Ltd.* case in 1896, that an auditor, appointed under an ordinary set of articles of association, is an officer. However, following the decision in *Bentinck* v. *Fenn* ((1887) 12 App. Cas. 652), for an officer to be successfully sued for breach of trust (Section 276) it must be proved that such breach caused pecuniary loss to the company.

Auditors have been sued for misfeasance in a number of cases: *Liverpool and Wigan Supply Association, Ltd.* [1907]; *re City Equitable Fire Insurance Co., Ltd.* [1924]; *in re John*

Fulton [1931]; *Sydney E. Smith* v. *G. Offer & Others* [1932]; *re S. P. Catterson & Son, Ltd.* [1937].

(iii) *Criminal Proceedings*—Where (as a general rule, in the opinion of the law officers) an auditor has been guilty of misconduct, he may be prosecuted under any appropriate statute of the criminal law. If, in the opinion of the jury, he has been proved guilty, he will be punished; here it is not a question of indemnifying the company, but of suffering punishment, e.g. imprisonment.

Cases could conceivably be brought against auditors under various Acts such as the Falsification of Accounts Act, 1875, but it is Section 84 of the Larceny Act of 1861 which is the most obvious piece of criminal legislation to which recourse is likely to be had where an auditor is concerned. Under that section of that Act proceedings will succeed against an auditor if it can be proved by evidence that he has published, or aided and abetted with somebody else in the publication of, a written document which is false in a material particular, having known such to be the case, and having acted with an intent to deceive.

It is, of course, difficult to prove all these things. An attempt was made to prove them in the *Klysant* case (*re Royal Mail Steam Packet Co.* [1931]), but it failed. The question at issue in that case was the non-disclosure, in the profit and loss account circulated among the members, of the reincorporation, over a series of years, to the credit of that account, of large balances set aside in past years to cover tax liabilities which had since been settled at a considerably smaller figure than that of the reserves made.

With reference to the above classification of possible actions against auditors, it is interesting to add that the fact that the *Royal Mail* action failed does not give any reason for concluding that one on the same matter brought under (i) or (ii) above would have failed. Presumably with the object of giving the maximum amount of assistance to the jury, Lord Wright, in his summing up, made some incidental remarks from which it has been inferred—and counsel briefed by the Institute of Chartered Accountants to express an opinion thereon did not go contrary to these inferences—that auditors may easily render themselves liable in civil proceedings if important and unusual entries have passed through the books on the profit and loss

account and these are not suitably referred to, in some way or another, in the particulars supplied annually to the general body of members.

3. The Judicial Interpretation of Auditing and Accounting Questions

(*a*) *General Tendencies of the Bench*—In dealing with actions which have been tried in the Courts, the Bench has, as a rule, not had to interpret complicated clauses of statute law (such as would, to a greater extent, have been the case under legal systems of the Roman pattern), since the statute does not attempt to go into great detail: English law is not so much in the texts as in the custody of the Judges who act, not only as interpreters of phrases, but as analysts of situations. Thus, judgments which have been handed down have tended to be characterized by:

(i) A disinclination to generalize and a close attention to the precise facts of each case and to all the particular circumstances which have given rise thereto. Basing themselves on the conviction that, although situations may be similar, they are never quite the same, the Judges, true to the English tradition of empiricism, have seen more value in meting out painstaking justice to those who have come before them than in enunciating general dicta for the guidance of all. Thus, the protection of British justice does not lie so much in it being known precisely what the law is, as in the confidence that the principles of the law will be scrupulously applied to each individual case. Time and again it has been stated from the Bench in cases affecting accountants that judgments have reference exclusively to the matter in litigation, and, in this connection, certain of the remarks of the Lord Chancellor in *Dovey & Others* v. *Cory* (*National Bank of Wales* case [1901]) are particularly interesting.

(ii) An emphasis on the importance of the spirit or intention of the law as distinct from the strict letter, and the exercise of great pains in the discovery of the motives for actions, especially regarding the presence or absence of good faith. This order of ideas was particularly well illustrated in certain remarks of Mr. Justice Vaughan Williams in *Towers* v. *African Tug Co., Ltd.* [1904], and also in the proceedings in *Pendlebury's, Ltd.* v. *Ellis Green & Co.* [1936].

(iii) The attachment of great importance to accounting, auditing, and commercial usage. Where difficult points have arisen the Bench has always tried through expert evidence to ascertain what other practitioners would have done in similar circumstances, allowance being made for the tendency of people to show more wisdom after an event than before it. The Bench has shown a considerable respect for usage: it has been reluctant to enunciate rulings which would tend to have the effect of tying the hands of officers of companies or of placing upon them as a whole responsibilities which would be unduly onerous, such as would cause inconvenience in the exercise of honest business and professional practice. These aspects have been clearly illustrated in the proceedings of *Kingston Cotton Mill Co., Ltd.* [1896]; *Newton* v. *Birmingham Small Arms Co., Ltd.*, [1906]; and *in re Republic of Bolivia Exploration Syndicate, Ltd.* [1913].

(*b*) *The Status of the Auditor and the Procedure concerning the Exercise of his Functions*—

(i) It is the members of the company who normally appoint the auditor—they can, if they wish, nullify the provisional appointment made by the directors prior to the first annual general meeting—who, if appointed under an ordinary set of articles, is an officer of the company; it is also the members who fix, either directly or, in practice as a rule by delegation to the directors, the remuneration of the auditor. Thus the relationship subsisting between an auditor and the body of members is that of contract, and is, as a consequence, governed by the general law of contract, implemented by the provisions of the company statute (including, of course, provisions which vest certain rights in a liquidator of a company), supplemented by any special provisions in the articles of the company. It follows from this that, in law, third parties are not concerned in the matter to a greater extent than would be the case in any other commercial contract, each party merely being called upon to observe the contract precisely and, in doing so, not to commit any breach of common law or of any law to which all people are subject. Auditors, jealous of their professional reputation and conscious of the need for a public accountant to maintain a high standard of conduct, will often decide to discharge their function in a manner which may more

than satisfy minimum legal requirements, but this is outside the legal purview of the matter, except where custom would render it implicit to the contract.

Given, therefore, that the auditor is responsible by contract only to the members, have third parties any enforceable rights against him? The answer is that up to now no action on this matter against an auditor has been brought in England: but judging from actions brought by third parties against one party to a business contract, it would be difficult for a third party successfully to sue an auditor for negligence (tort), and a very strong body of evidence would be required to prove a claim of misrepresentation (fraud).

The Courts have occasionally given judgment in favour of third parties, where they have suffered through the negligent execution of a contract, but the judgment in *Heaven* v. *Pender* (11 Q.B. 503) shows clearly that the Courts are disinclined to concede much to third parties, since it would in practice have the effect of inconveniencing undesirably contracting parties generally. So far as accountants are concerned the greatest protection seems to be derived from the ruling in *Le Lievre and Dennes* v. *Gould* [1893] (1 Q.B. 491), where it was held that a mortgagee had no redress in respect of losses on loans granted on the strength of certificates negligently issued by an architect to a builder (the mortgagor) who was his client.

Where it is a question of alleged fraud, contractual relationship is not relevant to the issue but, even if there be evidence that untrue statements have been made causing loss to a third party, actions are most unlikely to succeed unless it can be proved that the maker of the statement believed it to be untrue or was culpably ignorant as to its truth or untruth, i.e. was reckless in making the statement, and also that there was some intent by the maker of the statement that a third party of the kind to which the plaintiff belonged should act upon it. This seems to be the position following upon the judgment in *Derry* v. *Peek* [1899] (14 App. Cas. 337)—a case where it was sought to prove misrepresentation by directors in a prospectus—which succeeded other cases, e.g. *Evans* v. *Edmonds* ((1853) 13 C.B. 786), etc.

Charges under these headings were inconclusively

brought against auditors in the United States some years ago—*Ultramares Corporation* v. *Touche, Niven & Co.*, and the conclusions which seem to follow from English cases, and from the American case where an auditor was involved, are that if accountants act in good faith, there is little, under English law, to be feared from third parties; if third parties wish to avoid loss, it is for them to inquire as to the circumstances in which a certificate has been given before they blindly rely upon it. It is, perhaps, undesirable, for practical reasons, that the legal position should be otherwise.

Duty To Report Clearly To Members

(ii) It is the duty of the auditor to report clearly to the members; any attempt by him to exonerate himself by reporting to the directors only what should have been reported to the members will fail if an action is brought against him. The fact that it can be proved that he has reported to the directors on certain matters may implicate them more categorically but, at the same time, it will usually render quite clear that the auditor has not acted in perfect good faith (*London & General Bank, Ltd.* [1895]; *Dumbells Banking Co., Ltd.* [1900]; *Arthur E. Green & Co.* v. *The Central Advance & Discount Corporation, Ltd.* [1920]).

The principle enunciated above seems elementary, but the matter has been before the Courts on several occasions as the above cases indicate. Moreover, from two fairly recent cases—*Pendlebury's* v. *Ellis Green & Co.* [1936], and the action brought in February 1937 by the Liquidator of S. P. Catterson Ltd., Mr. H. L. Bell, against the auditor, Mr. C. R. Beeby—it has become clear that precisely what limits are to be set to what falls within the scope of the principle can give rise to doubt.

In both the cases cited immediately above, the matter at issue was the accounting system, it being established that the auditors had definitely reported to the directors, but not to the members as such, that defects therein were apt to endanger the receipt by the company of all the revenue earned. Unfortunately, in both cases—particularly in the former—the circumstances were special: private companies were concerned; in Pendlebury's the directors and members were exclusively the same parties; in the *Catterson*

case it was not the members who sued in an ordinary civil action, but the liquidator under a misfeasance summons.

In *Pendlebury's* case it was laid down that despite the wording of Section 134 of the Companies Act, and the ruling in *Salomon* v. *Salomon* [1896], that a company is a distinct entity from the members who compose it, the statute had, in effect or spirit, been observed; there was no need to qualify the report, since the directors as such had been informed, thus automatically they could be considered to have been informed as members.

The *Catterson* case, however, is much more significant for our present purpose. In it the Judge stressed the fact that the parties primarily responsible for the administration of the company were the directors, and it seemed that he regarded this as even more pertinent *re* questions of system than *re* the preparation of annual accounts; this the more so, since the judgment went on to imply that questions of system, purely as such, were outside the terms of reference so precisely laid down in Section 134 of the Companies Act of 1929—wording copied from the previous Act. It is possible that Mr. Justice Bennett was anxious to circumscribe the liabilities which might otherwise seem to fall on auditors under Section 274 of the present Companies Act, thus introducing doubts as to what might now be required under Section 134. The positive result of the case is to render certain that it is the duty of auditors to express very clearly their views on faulty systems to directors; moreover, having done so, auditors are in a much stronger position if action is taken by a liquidator under Section 274 of the present statute. Furthermore, the Judge was careful to include in his ruling an incidental observation to the effect that it is the auditor's duty to endeavour to ascertain that the company has received all that it should have received in order to see that the balance sheet is correct, since in it appears the profit and loss account and auditors have to verify the trading results. This remark is of considerable interest in connection with matters discussed in Section 4 of this article.

Neither the directors nor the members have any power definitely to restrict the scope or free exercise of the audit function, and no power whatever to curtail the liberty of the auditor to report as he deems fit. However, it has in

the past been held that an internal regulation of a company whereby an auditor is to be indemnified by the company with respect to damages resulting from a successful action brought against him is not *ultra vires.* (*Newton* v. *The Birmingham Small Arms Co., Ltd.* [1906]; *re City Equitable Fire Insurance Co., Ltd.* [1924].)

The protection which an auditor might derive, however, from an indemnity clause in the articles of association has been materially circumscribed by the provisions of Section 152 of the Companies Act now in force, he being protected by an indemnity clause only in the event of the failure of an action in which he is the defendant, i.e. in respect of any expenses to which he has been put in defending himself.

SCOPE OF AUDITOR'S FUNCTIONS

(iii) The auditor is called upon to examine the accounts and to report thereon (counsel consulted by the Institute was of the opinion that the Report might be in the form of a certificate). It is no part of his duty to give advice either to the directors or to the members as to what he thinks that they should do, and it is absolutely no concern of his, in the exercise of his statutory function, whether the business is being well or badly managed, provided he does his own duty, a duty which, however, is, as a rule, more easily discharged if the company's affairs are well conducted. His duty is not done, however, merely by comparing the figures shown by the books with those appearing in the balance sheet, nor even by checking the arithmetical and bookkeeping accuracy of the figures in the former, and he is not necessarily expected to make a complete check of such figures from that point of view. What he must not fail to do is to endeavour to ascertain whether transactions have occurred which are at variance with the statutory powers governing the activities of the company in question, and whether the balance sheet, for which the directors are responsible, is, at least in general terms, a true representation of all relevant facts concerning the financial position of the company. His unqualified report must never be taken necessarily to imply that the published accounts are drawn up in the clearest possible way; it must, however, provide the members with the assurance that nothing of material financial importance is completely hidden from them or misrepresented in the published accounts when read with the report of the di-

rectors thereon. (*Leeds Estate Building and Investment Co.* v. *Shepherd* (1887); *London and General Bank, Ltd.* [1895]; *Dumbells Banking Co., Ltd.* [1900]; *re Royal Mail Steam Packet Co.* (criminal case) [1931].)

(iv) An auditor is not expected to approach his task with a feeling of suspicion, i.e. to adopt, as a general rule, the attitude which is appropriate in a detective (his duty being one of verification rather than of detection); he is, nevertheless, expected to use ordinary care and skill in the discharge of what is not only an expert, but a fiduciary, function, calling above all for perfect good faith on his part. He must not certify that which he has not adequate reason for believing to be true but, provided nothing has occurred to excite his suspicion, he will have such adequate reason if he has generally examined the financial books and certain other records, i.e. those having some direct relation thereto, and, in connection with such examination, has asked for and received what he deems to be the necessary information, which appears to him to be bona fide and accurate, from the directors or other trusted servants of the company answerable to them. If, however, circumstances arise such as to be calculated to render a conscientious expert suspicious, he must go farther than he otherwise might decide to go, so that he may become satisfied that any suspicion which he had was unfounded. An auditor is never a guarantor of the accuracy of what he certifies—the statute permits him to regard his report as his opinion, except that, of course, he is required definitely to state whether he has received all the data which he has required. (*London General Bank, Ltd.* [1895]; *Kingston Cotton Mill Co., Ltd.* [1896]; *Irish Woollen Co., Ltd.* v. *Tyson & Others* [1900]).

(v) Where an auditor has been appointed with more explicit instructions, so that more is required of him than execution of his function under the statute, or where he fulfils no statutory function, the Courts will have regard to the terms of such instructions in giving their decisions and they will, in accordance with the law of contract, consider closely the terms of the arrangement—expressed or implied—in conjunction with current professional usage as ascertained by the evidence obtainable from expert witnesses. (*Wilde and Others* v. *Cape & Dalgleish* [1897]; *Martin* v. *Isitt* [1898]; *Irish Woollen Co., Ltd.* v. *Tyson and Others*

[1900]; *Charles Fox & Son* v. *Moorish Grant & Co.* [1918].)*

Sometimes auditors, whether acting statutorily or otherwise, have been referred to as agents of those employing them, but there is now no doubt that the relationship has its legal basis in the general law of contract. In a recent case—*Sockockinsky* v. *Bright, Graham & Co.*, in the Mayor's and City of London Court, November 1938—the agency thesis was unsuccessfully put forward in order to endeavour to obtain a Court order for the handing over by accountants (who had prepared figures for income-tax purposes) of their working papers, correspondence, etc. to their client. It was, however, held that such documents might be retained, since the discharge of accountancy, etc., work was in the nature of independent contracting. This decision is one of considerable practical importance, since, prior to it, there was no absolute certainty that a similar ruling given in a United States case—*Ipswich Mills* v. *Dillon* [1927]—could be relied on implicitly in Great Britain by professional accountants.

(*c*) *Concrete Examples*—Litigation has not occurred in connection with every conceivable type of item which may appear in published accounts, but enough actions have now been brought for it to be possible to state the following:

It is the duty of the auditor to ascertain as best he can that the assets, etc., represented by figures in the balance sheet exist in fact as well as in law, and that the legal and factual status of the assets is clear from the published accounts. In particular—

(i) If any asset is, by the operation of the law, mortgaged or otherwise charged this must be stated.

(ii) Whilst an auditor is not responsible (unless he has accepted special instructions) for the correctness of stock-taking, he is expected to see that orderly records thereon exist, to examine them and to call for any explanations which such examination renders necessary or desirable.

(iii) An auditor is expected to obtain the verification of the unencumbered existence of title deeds, etc., and certificates for investments, etc., in the hands of third parties, but where scrip is in the hands of those who are not generally considered to be permanent depositories of scrip, e.g.

**Note*: These cases have revealed how important it is for auditors carrying out a non-statutory function to have the arrangement with their clients clearly defined in writing.

stockbrokers, his duty will not, as a rule, have been discharged if he has not seen the scrip itself.

(iv) Whilst it is not necessarily the duty of an auditor to count cash in the hands of the officials who are stated to keep it, he must satisfy himself that the cash funds exist. In such a case as this, much will depend on the size of the funds and the circumstances surrounding their location.

(v) The examination by an auditor of debtors' accounts must be more than of a purely clerical nature: he must endeavour to ascertain whether counterclaims exist which are capable of reducing the value of the debt; if debts are overdue, he must obtain explanations to elucidate whether there is reasonable chance of collection, and he must see that the collection is not statute barred. The auditor is not obliged to obtain certificates from individual debtors and creditors, but circumstances may arise where he would be justified in pressing for certificates to be obtained. (*Kingston Cotton Mill Co., Ltd.* [1896]; *London Oil Storage Co., Ltd.* v. *Seear Hasluck & Co.* [1904]; *Henry Squire* (*Cash Chemists*), *Ltd.* v. *Ball, Baker & Co.* [1911]; *Arthur E. Green & Co.* v. *The Central Advance and Discount Corporation, Ltd.* [1920]; *re City Equitable Fire Insurance Co., Ltd.* [1924].)

These concrete examples must not be considered as covering all the features of an audit; they consist merely of matters which have been in litigation up to now. It is not, of course, an object of this article to deal with auditing technique as a whole, nor even to comment fully on the duties of an auditor arising out of the specific provisions concerning accounts contained in the statute, e.g. those of Sections 124-8 of the Companies Act, 1929, introduced into the statute with the object of obliging all companies to conform with a minimum standard of clarity in their published accounts.

(*d*) *Dividend Payments*—Owing to an element of inevitable conflict between the interests of preference and ordinary members of a company—and of possible conflicts between the company and its creditors—and to the difficulty of establishing rules easy to apply to each case, there has been a certain amount of litigation to decide whether a given dividend declaration was, or was not, legal. Broadly speaking, dividends are, in accordance with best commercial practice, paid out of net trading profits intact after liquidating trading losses (if any) incurred in the past, and

profits of a capital nature are, as a general rule, considered not to be available for dividends. It has, however, been established that dividend declarations which do not fall within the terms of this statement—and would, therefore, be considered by most accountants to be, in principle, unorthodox—may quite easily pass the test of legality.

Before embarking upon a study of these matters, it is important to note that:

(i) No British Companies' Act has ever contained an attempt to define profits or to enumerate the sources out of which dividends may be paid; all that the statute has done is to prohibit—except in clearly defined special circumstances for which strict rules of procedure are laid down—the return of capital to shareholders. In a positive sense, therefore, the statute is silent on the subject. (It should, nevertheless, be mentioned that Clause 91 of Table A precludes the payment of dividends otherwise than out of profits.)

(ii) Auditors have no direct statutory responsibility under the general Companies' Acts in connection with the declaration and payment of dividends: the only circumstance in which an action *re* dividends—where the declaration was not *ultra vires*—would lie against the auditors would be where the members could prove that their resolution to pay a dividend had damaged the interests of the company, and that in passing this resolution they had been misled as to the financial position owing to a failure of the auditors to do their duty in reporting on the balance sheet.

Evidently, it behoves auditors to be more careful as to what they are prepared to certify if they think that a dividend, which they deem inadvisable, is likely to be paid.

It follows from what has been set out that:

(*a*) Great responsibility falls upon directors in recommending members to pass resolutions for the declaration of dividends. Where they recommend a dividend in somewhat unusual circumstances it behoves them to acquaint the members with all the relevant facts. This will not, of course, render legal what would otherwise be illegal, but it will, in practice, materially circumscribe the rights of redress of the members *vis-à-vis* the directors (*Towers* v. *African Tug Company, Ltd.* [1904]; certain remarks in the judgment in *The Ammonia Soda Co., Ltd.* v. *Arthur Chamberlain & Others* [1917]).

(*b*) The decision as to whether a dividend can or cannot be legally paid may depend upon the statutory powers of the company, e.g. the "objects clause" of the memorandum of association, and it is, of course, the duty of the auditor in this respect to ascertain that such powers do not conflict with any dividend which has been declared for which the payment appears in the accounts which he is examining. A dividend which would otherwise be legal will not be so if its declaration conflicts with the powers of the Company (*Wall* v. *The London and Provincial Trust, Ltd.* [1920]); conversely, a dividend which is, in a general sense, illegal cannot have legality claimed for it by virtue of the terms of the company's powers, such terms being in this respect *ultra vires.*

(*c*) The decision as to the legality or otherwise of dividends is a question which depends in a special degree upon the facts of each case so that the task of the Bench has not always been an easy one. As the Judge said in *Bond* v. *The Barrow Hæmatite Steel Co., Ltd.* [1902]—taking the same line as had done the Lord Chancellor in *Dovey & Others* v. *Cory* a year earlier: "there is no hard and fast rule by which the Court can determine what is capital and what is profit." He refused to agree that the facts in that case—one where the action was to compel, and not, as has been more frequent, to restrain, the payment of a dividend—were similar to those in certain others, but, apart from that, he made it clear that the position of the Court was altogether stronger in a case for restraint of a dividend than in one for compulsion to pay one, i.e. the Court would scarcely order the directors, acting in accordance with commercial considerations, to do what they judged it impolitic to do.

In a word, the Judges have endeavoured to interfere as little as possible in dividend policy; but they have occasionally hinted that they consider that a standard of prudence higher than that demanded by the law is desirable—good law might be bad business as the Judge said in *Verner* v. *The General and Commercial Investment Trust Ltd.* [1894]. It is, in consequence, a pity that accountants have not been more successful than they have been in securing a more general acceptance of sound accountancy principles as a basis for company finance. In particular, it is desirable that companies should in their accounts always adhere to a strict observance of the distinction between capital reserves (non-trading surpluses in the ordinary sense) and revenue re-

serves (undistributed trading profits), since this would have the effect of tending to curtail the practice of declaring dividends, at least partly, out of non-trading surpluses. Accounts do not show the financial position of a company in a way to offer the maximum assistance *re* dividends where a general reserve account contains undistributed trading profits, premiums on shares, profits on capital assets realized, etc., relating to a series of years gone by.

(*To be concluded*)

CONSUMPTION STANDARDS AND THE HOUSING PROBLEM

By John L. McDougall, Kingston, Ontario

FOR TEN years unemployment and relief have continuously been major problems confronting the Canadian people and the hardest core of unemployment has been the workers who no longer find employment in the building industry. It is a situation which challenges action. At the end of the last century a rising level of construction activity was usually one of the major forces putting an end to the depressions (usually short) which then ruled. We need houses now just as much as we did then, yet the nation is less well housed now than it was ten years ago. The population has increased by some fifteen per cent. It is tending to move toward new occupations to be followed at new centres so demanding even more construction than would be expected from the rise in total numbers alone. Yet little happens. Unemployment remains; the housing shortage grows steadily more acute. In an attempt to remedy the situation the government passed the Housing Act in order to reduce the cost of mortgage money to five per cent. for builders of new houses and make it possible for them to get money on a smaller equity than any moderately careful lender would consider without the partial government guarantee. It was followed by the Home Improvement Scheme to make it possible to borrow cheaply for the reconditioning of older properties. Both schemes received very extensive publicity at their inception and have been very widely welcomed but their net effect is disappointingly small. A very important part of the work done would have been done anyhow, even at higher costs for money.

Reduction in the cost of money is no doubt welcome to such persons but not crucial. Only the balance in which the lower cost of money was a deciding factor can be treated as a net gain from the operation of these acts.

Faced with these facts, well-meaning enthusiasts have poured forth long memoranda on the awful "housing problem" and have called for outright subsidization in order to meet this need which a failing economic system can no longer fill. Tougher-minded business men are inclined to look with suspicion on the well-meaning and to mutter darkly about the weight of taxation (made necessary by an extravagant scale of social services) being so great that its very weight makes building impossible—so adding to the numbers on relief and therefore to taxation and so *ad infinitum*.

There is, as usual, something to be said on both sides. The housing of a very considerable portion of the population leaves a good deal to be desired, and anything reasonably practicable should be done to improve it. It is equally true that the financing of urban municipalities on the real estate tax is an anomaly. It began when expenditures were limited to those which clearly benefited property owners. The municipality in effect did for them collectively what they could not do individually. Roads, waterworks and sewage disposal are examples of such expenditures. The tax system has remained unchanged, but the character of the expenditures is completely altered. It is also important that urban taxes have shown a perverse tendency to rise over the last ten years in the face of a general fall in incomes, but that merely aggravates a position which was already unsound.

Changes in Consumption Habits

There is, however, a factor which both parties have tended to leave out of the discussion, namely the wants of the people who live in the houses. Do people want houses as intensely as they did fifty years ago? It is impossible to say with any accuracy. One can suggest that they do not. The possession of an imposing house was one of the ways in which a man established himself then as a solid and respectable member of the community. Today his opposite number trades in last year's Magnificent Super-Eight for a new Super-Colossal V-12 and takes a member-

ship in a second golf club. The purpose is the same, but the objects of expenditure have changed.

This may all be true, but can one *prove* that home means less now than it did then? It can't be done. One can suggest this or that very strong consideration why it seems so, but proof is impossible. The element of time is an insuperable barrier. It is possible, however, to compare the expenditures of people at different levels of income at one time to see how they spend their money. If the assumption is made that people are fundamentally the same over the middle segment of the income range then the differing applications of funds as income increases show the relative urgency of the various wants. Thanks to a recent survey of family expenditure[1] made by the Dominion Bureau of Statistics it is possible to make that kind of comparison. It is not one which brings any great measure of consolation to the proponents of housing schemes. It would appear as if Canadians of British origin were not particularly keen on additional house room when they have additional money to spend. As income rises the proportion which is spent on housing steadily falls. Those in the $400-$799 income group spend 21.3 per cent. on housing; those with $2400-$2500 spend 15 per cent. But transportation (including automobile) expenditures are altogether different. Those with the least income spend only 1.6 per cent. on this item, but it is one of the earliest and strongest claimants on any increase in income and those at the top of the scale spend 10.9 per cent. of their incomes upon it. Only 4.4 per cent. of those in the $400-$799 income group had cars, against 57.4 per cent. of those with $2000-$2500. In other words they did want the freedom of an automobile and were will-

[1] *Family Living Expenditure in Canada. Wage-Earner Family Expenditure and Income* (Ottawa: Mimeo, 1939). Price 25 cents.

This survey covered annual earnings in the year ending September 30, 1938, of 1439 families of two parents and one or more children. 1135 families of British origin were covered in Charlottetown, Halifax, St. John, Montreal, Ottawa, Toronto, London, Winnipeg, Saskatoon, Edmonton and Vancouver; 211 French families in Montreal and Quebec and 93 families of other racial origin in Montreal and Winnipeg. Income per family ranged from $450 to $2,500 per year.

A roughly comparable study has also been made in the United States. Those who are interested will find it summarized in the *Monthly Labour Review* for March, May, June, September and December 1936. See also U.S. Bureau of Labour Statistics Bulletin No. 642, *Family Income in Chicago 1935-36* (Washington: 1939).

ing to pay for it; they did not really want much additional housing so they reduced its proportion to the total outlay.

The behaviour of the families of French origin was rather different. They showed quite as marked a reduction in the amounts which they spent on housing, but the saving did not go into transportation which really rose hardly at all. The difference came in the composition of the family. The number of children per family in the Anglo-Canadian group was completely unrelated to income. The average for all incomes was 2.3. The range was 2.2 to 2.4. As income rose the number of rooms per person rose from 1.0 to 1.3. In the families of French origin the number of children rose steadily with the size of the income from 2.1 in the income group $400-$799 to 4.9 in the group $2,000 and up. The number of rooms per person was practically constant throughout the income range at 0.9. If this relatively small sample represents group preferences accurately, French-Canadian parents when faced with an increase in income elect to have children; Anglo-Canadians have no more children and are therefore left with larger amounts of free money to spend on other things, automobiles being one of the strongest claimants on the free funds. For neither group is housing a strong claimant; it stands somewhere near the bottom of the scale of preference.

The Problem of Policy

If we are to move toward a regimented economy then this study means nothing. If the planners decide that more residential construction is needed, additional housing will be built to such plans and specifications as seem best to those making the decision; but if a remnant of choice is to be left to us the answer is clear and unequivocal. A certain amount of house room is a compulsory purchase. No matter what its cost we must have it. But at present levels of cost, other goods bring in a much higher return of enjoyment and are preferred when additional instalments of income are to be spent. Therefore all the activities of government in this field—the Dominion Housing Act, the Home Improvement Plan, the coming Mortgage Discount Bank—are so many efforts to make water run up-hill and those who propose them are prisoners of memory who are meeting the problems of the 1930's and '40's with solutions proper to the 1880's and '90's.

The answer is much more fundamental than any possible

tinkering with the cost of money. The fact is that the housing industry has over a long period fallen far behind others in improving the quality and reducing the cost of its product. If an 18th century bricklayer or carpenter were set down on a so-called modern job he would fit in perfectly without any training period. The methods in use are those to which he is well accustomed. He might be a little surprised by the rigidity with which the bricklayers held output down below the levels which he had been accustomed to think of as normal, but he would have nothing to learn about his trade. It is still a matter of hand work on the job. Every other industry has migrated to the factory where labour can be applied so much more effectively and where, also, wage rates per hour tend to be lower. Factory goods as a class have become so very much cheaper than housing that the price disparity has finally forced a modification of the scale of preference. Men would still like to enjoy the permanence of owning their own homes, families still enjoy good living quarters, but with relative costs what they now are, they reduce to the minimum the amount of house-room they consume and expend the balance of their income on other things.

We come, therefore, to the conclusion that if we lived in a wholly rational state in which action was always based on the permanent interests of the whole body of citizens, we should find the government boldly financing experiments in factory construction of interchangeable units which could be easily and quickly erected by any competent mechanics. In that way costs would be reduced, and the foundation laid for a sound revival of building activity. But we do not live in a rational state. We puddle along trying to make a system already obsolete last a little while longer. Government is in effect intervening to make financing cheaper so that the gain may be absorbed by the existing inefficiencies. Somehow, the end does not seem quite adequate to the effort involved.

CANADA'S CENTRAL MORTGAGE BANK

By G. R. G. Baker, Toronto

A FEW weeks ago Canada learned with regret of the departure from the Parliamentary scene of one of its most faithful servants, the Hon. Charles A. Dunning, Minister of Finance, whose health did not permit him to continue to carry the heavy responsibilities of his office. The final legislative task of this honoured minister was the piloting through the House of an act to incorporate the Central Mortgage Bank.

Need for the Act

In introducing the parliamentary bill and explaining the need for the act, Mr. Dunning drew attention to the impact of the government's easy money policy upon rates of interest generally and the effect of low interest rates, obtainable under the *National Housing Act*, upon the cost of new mortgage money, then went on to say:

> All of us however are aware of the tremendous backlog problem in the mortgage field with respect to obligations undertaken years ago which have not yet reached maturity and which carry interest rates higher than the current rates on new money and rates which, owing to conditions which have prevailed especially in some parts of Canada, have proven unduly onerous at the present time.
>
> There is a secondary aspect of the problem which is sometimes given, I think, too little consideration, and that is the fact that while the mortgage debtor is in difficulties, particularly when he is a debtor who cannot fully meet his obligations under present conditions, it is also true that the creditor to whom the mortgage debtor owes the debt is himself a debtor. I can illustrate that by taking two very common examples. In many cases the creditor of the mortgage debtor is the life insurance company. The life insurance company in turn is the debtor to its policyholders. Most mortgage companies are debtors to two classes of people, their debenture holders and their savings depositors. A trust company is in the same position. So when in our thinking we stop at the primary debtor and fail to follow through, fail to remember that the creditor of the primary debtor is in the great majority of cases also a debtor to a great group of creditors, very often a large proportion of the Canadian people—unless we recognize that fact we are not taking a realistic view of the mortgage problem.

Because the problem was a national one Parliament felt justified in pledging the national credit, as it does in this

Act, for the solution of the mortgage problem, but the provisions of the bill nevertheless imposed upon the lending companies who participate in the scheme a heavy sacrifice of assets and income as well as a surrender of control over their lending policies, if they borrow from the bank.

Participation by lending companies and borrowers from them is entirely voluntary, and necessarily so, for legislative jurisdiction over mortgage contracts is vested by our constitution in the provinces, under the head of property and civil rights. Parliament, therefore, showed a willingness during the progress of the bill through parliament to lessen the sacrifices required of the lending companies, in order to secure the co-operation of a substantial number of them and so ensure the success of the adjustment plan.

Organization of the Bank

In order to administer this plan of adjustment for mortgages in Canada, it was proposed to set up a central mortgage bank, controlled by the Dominion Government, which would supply its capital and guarantee its debentures. The capital was fixed at ten million dollars divided into shares of a par value of one hundred dollars each, and the bank was authorized to issue debentures not exceeding in principal amount two hundred million dollars.

The bank has now been organized and, in accordance with the Act, it is under the management of a board of directors, composed of a governor, a deputy governor, the Deputy Minister of Finance and three other directors, namely: Philip A. Chester of Winnipeg, F. W. Wegenast, K.C., of Toronto, and J. A. Brillant of Rimouski.

The governor and deputy governor of the Bank of Canada hold the same positions, ex-officio, with the Mortgage Bank and it may be noted that the Deputy Minister of Finance is also an ex-officio director of the Bank of Canada. A general superintendent has also been appointed as head of the Central Mortgage Bank, in the person of Mr. David B. Mansur, a young man of wide experience and marked ability in mortgage matters.

Plan of Adjustment

The Act contemplates a membership within the bank's organization of mortgage, loan, trust and insurance companies. These will enter into an agreement with the bank to adjust all the mortgages on their books according to a

formula set out in the Act, and the bank will undertake to contribute a certain proportion of the loss resulting to each company.

With respect to farm mortgages, entered into before 1st January 1939, all arrears of interest owing in excess of an amount equal to that for two years will be written off. The amount of the mortgage account then remaining will be reduced by an amount necessary to fix the amount of the account at eighty per cent. of the value of the farm and the resulting total will be consolidated as a principal amount, upon which interest will run at not more than five per cent. per annum.

In the case of mortgages on non-farm homes entered into prior to 1st January 1936, not including business properties, and excluding all homes where the total amount owing on the mortgage account exceeds seven thousand dollars in respect of single family dwellings and twelve thousand dollars in respect of two-family dwellings, the adjustment will be the same as for farm mortgages, except that the interest rate will be five and one-half per cent. There is no valid reason for the differential between the interest rates, because the risk of loss is usually greater in the case of farm mortgages, but it was recognized that the problem with respect to farm mortgages was more acute and required more generous treatment.

The term of the mortgages will also be adjusted in many cases over a longer period so as to provide for payment of interest and principal amortization and, in the case of non-farm mortgages, for taxes as well. In the case of mortgages on the security of grain-growing farms, provision will be made for payment of principal and interest on a share of crop basis.

The length of the term in every case will depend upon the category, approved by the bank, into which the mortgage falls. In some cases it may extend for twenty years, if for example, the mortgage account has not been paid down to a low percentage of the property's value and if the future life of the property can be anticipated as a long one.

Like nearly every other scheme of blanket debt adjustment, it may be noted that this one gives no credit to a debtor who has kept up his mortgage payments to the letter as against one who has neglected his obligation and

allowed arrears to accumulate, and takes no account of the debtor's ability to pay.

One can see that to make such adjustments will require considerable sacrifices on the part of member companies, although they recognize that by reducing the amount of these mortgage accounts, where the borrower is finding it difficult at present to pay, and thus making it easier for him to make his mortgage payments, the security for the adjusted amount of the mortgage is improved.

The whole shock of the reduced rates of interest must, however, be borne by the companies making the reduction. There is no compensation offered by the bank at all with respect to this loss of annual revenue. There is a further loss of income to the companies by virtue of the reduction in the principal amount of their mortgages. In some few cases the write-off of this principal amount does not represent a complete loss because it may not be wholly collectable, but in the vast majority of cases it does represent a collectable asset and one upon which interest will be promptly met, and so contribute to the companies' annual revenues. For this loss of a principal asset and a revenue source the bank is prepared to contribute one-half of the principal amount, in the form of non-transferable serial debentures, payable over twenty years and bearing interest at three per cent. The same contribution will also be made with respect to interest arrears which are written off at the date of adjustment.

Mortgages Eligible for Adjustment

The fact that the Act does not apply to dwellings and duplexes, above a certain price range, has already been mentioned and also that it does not apply to commercial properties. It cannot apply to mortgages on the security of multiple dwellings, such as apartment houses, nor to mortgages held by companies that do not become members of the bank nor to mortgages held by private individuals.

If a mortgage is held by a trust company for an estate or agency account, it does not come under the Act, even though it be taken in the company's own name, because the conditions under which the trust or agency were assumed do not permit the company to deal with it in this way.

The Act does however apply to agreements of sale held by member companies, where property has been purchased on an instalment contract, just as it does to mortgages.

Banking Facilities Available

Features of the Act which received much prominence in the early stages were the borrowing powers of the member companies. To many the bank was then regarded as simply a mortgage discount bank, but when the Act finally emerged the debt adjustment features overshadowed all others. This was accentuated by the fact that insurance companies, who have much more owing to them on the security of mortgages than the total owing to both mortgage and trust companies combined, cannot, and in any event probably would not wish to, avail themselves of the borrowing privileges offered by the Act.

The borrowing privileges are of two kinds, namely:

(1) A right is given under section 16(2), when contracted for under the membership agreement, to sell to the bank, bonds, debentures or certificates, bearing interest at three and one-half per cent., to an amount not exceeding that of the mortgages adjusted by the company in pursuance of the Act.

(2) The bank may also buy such evidences of indebtedness from a member company bearing interest which is less by, at least, one and one-half per cent. than the rate to which the company is restricted in charging its borrowers on current loans, as explained hereafter. It is provided however that the bank may not lend more to any company than the total principal amount of adjusted mortgages held by the company and of those subsequently entered into in accordance with restrictions set out in the Act, which are called "eligible" mortgages, unless the proceeds of any surplus are to be utilized solely to make loans on the security of "eligible" mortgages.

The first power is regarded as a safeguard, enabling companies to make long term adjustments, at the low rates of interest required by the Act, with the assurance that when debentures or savings certificates they have issued to the public come to maturity they will be able to secure funds to replace them at the necessary low rates, in order to carry the adjusted mortgages on to the new maturity date, even though interest rates may have risen in the meantime. The privilege of borrowing money to loan on "eligible" mortgages will enable companies to extend their lending facilities and at a lower cost—because of the saving of

certain expenses incurred in selling such securities to the public.

Future Control of Lending Policies

The control to be exercised by the bank over the future lending policies of the member companies was a paramount feature of the bill when introduced, and gave rise in some quarters to a charge that the government was embarking upon a program of state socialism. Loan companies did not appreciate any such restrictions upon their power of deciding as to the course of operations and policies of their business, especially where they had not borrowed from the bank. The government finally agreed that no control would be exercised by the bank over the lending operations of any company nor the interest rate at which mortgage money would be loaned and the type of security to be taken, unless such company was itself a borrower from the bank. In case a company does borrow however, the bank will determine the rate of interest to be charged and it is not to exceed by more than two per cent. the average yield from time to time on long term obligations of the Dominion of Canada over selected three month periods. On renewals of mortgages on non-farm homes the company will not, however, be obligated to charge a rate of interest less than five and one-half per cent.

Problems to be Solved

Although the Act has been proclaimed (14th July 1939) and the staff of the bank selected, there are many points still to be settled. The adjustment date must be decided upon but this is complicated by the fact that in some provinces provincial legislation unduly impedes or restricts the mortgagee's right to realize upon his security. Until these provinces have removed such barriers, at least to the extent of exempting mortgages adjusted or to be adjusted under the Act, member companies are not obliged to make adjustments in any such province.

The provinces of Manitoba and Saskatchewan have already evinced a willingness to "clear the decks" in those provinces, at a special session if necessary, and when they do so the possible adjustment date will be brought appreciably nearer. Although some provinces may not co-operate by removing legislative impediments, a general adjustment date may be fixed for all Canada except such provinces, and

a later date fixed for each of them, when they have passed legislation necessary to remove restrictions imposed.

One of the most important preliminary problems to be dealt with is that of the level of valuations. Before any company can decide whether it can afford to become a member of the Central Mortgage Bank it must have some idea of what it is going to cost. If appraisals finally made indicate that accounts must be written down very extensively below the figures at which they are carried on the books of the company, the cost of making such an adjustment may be prohibitive.

An appraisal will not be made of every property upon which there is a mortgage capable of adjustment, for the Act permits the bank to accept, subject to further investigation, any appraisal agreed upon between the debtor and the member company. However, it is likely that a great many properties, both farm and urban throughout Canada, will be appraised by the companies and by the bank, in order to serve as a guide to the valuation of other properties of the same general type.

There are many terms used in the Act which require definition by order-in-council, as the Act provides, and it will be a matter of great importance how certain terms are defined such as: "amount owing on the mortgage account" and "arrears of interest." A membership agreement must also be drafted and regulations made as to various matters under the authority of the Act.

Until these questions are settled a company signing a membership agreement would be signing a blank cheque, leaving it to the bank to fill in the amount.

Expected Results of Adjustment Plan

The affairs of the bank are in their formative stages as yet, but it would appear that there will be sufficient co-operation on the part of lending companies to ensure the bank's successful operation. One may venture to hope that as a result of the Canada-wide adjustment of mortgage debt a healthier relationship between debtor and creditor will ensue, unencumbered by legislation restrictive of the freedom of contract which is necessary for the easy flow of credit. *The Farmers' Creditors Arrangement Act*, it may be noted, does not apply to adjusted mortgages, or those to be ad-

justed, unless the debtor refuses the adjustment offered under the *Central Mortgage Bank Act*.

It is felt that when the Act comes into full operation it will also have a profound effect on mortgages held by individuals, as well as companies which do not become members of the bank, because mortgages held by them, if matured, may be refinanced by companies which are members of the Central Mortgage Bank, thus tending to maintain the low interest rates provided in the Act as a general rate for all better types of mortgage investments.

Most important of all, the adjustment proposed should enable thousands of borrowers, who have been carrying on at some sacrifice through economic difficulties for which they are in no way responsible, to finance their homes more easily and gradually reduce the amount of debt outstanding against them.

ACTION ALLEGING NEGLIGENCE AGAINST AUDITORS DISMISSED

Diamond T. Montreal Limited v. James G. Ross et al. and Frank B. Wadsworth

By judgment rendered 13th July 1939, Mr. Justice Charles A. Duclos of the Superior Court of Quebec dismissed, with costs, the action brought by the above company against its auditors and an employee of the company, Frank B. Wadsworth. The auditors were appointed as such in 1932 and continued until the end of the company's fiscal period in 1936. During all of that period, and longer, the defendant, Frank B. Wadsworth was employed by the company as accountant and secretary-treasurer and, while not bonded, virtually had full charge of the bank deposits, accounts receivable, cash and all financial transactions or dealings made by the company for some years. Wadsworth, during the two and one-half years preceding the termination of his employment on 15th December 1937, converted to his own use nearly $7,000. The method adopted was to retain for his own use payments made by sundry debtors of the company. Such debtors were not credited on the company's books with the amounts so paid but when Wadsworth periodically furnished the president of the company with lists of all accounts receivable the actual amounts

owing were shown. Of the total amount of approximately $7,000 misappropriated, about $2,000 was misappropriated prior to the termination of the contract with the defendant auditors. This sum, namely, $2,157.68, was misappropriated during the year ending 30th September 1936.

Relations With Auditors

For the last year during which the auditors acted for the company the audit fee was reduced whereupon the auditors notified the company that they would only make a balance sheet audit at the end of the year leaving the responsibility of the current year's transactions up to the company. The audit for the year ending 30th September 1936 was delayed to such an extent that the auditors wrote the company on 15th December 1936, pointing out that as they had not been supplied with inventories which had been listed and valued they were unable to complete their audit. The auditors also wrote the company on 6th July 1936, urging that all employees who handled cash or small items of merchandise should be bonded and pointing out furthermore that no system of internal check existed in the office, and they reminded the company that they had made the same recommendation on several previous occasions.

Judgment

The learned Judge pointed out that the auditors had not made Wadsworth dishonest and they had not caused the loss. If they had discovered the loss, their simple duty would have been to report it but it would have already been incurred. The books were in perfect balance and the loss did not arise from any falsification of the books. There was only one way in which the dishonesty could have been discovered, namely, by the auditors sending to each debtor a notice of the amounts which the books showed they owed and asking them to certify as to the correctness of the amounts. This the auditors could not do unless specially authorized, and the learned Judge stated that they had asked the president for this authority and were refused. All the officials of the company liked and trusted Wadsworth, and His Lordship stated that he was satisfied that if the auditors had become suspicious of Wadsworth and had communicated the suspicion to the president, the president would have stated that he knew nothing about the books

and had implicit confidence in Wadsworth. The president had an opportunity to check the statements being sent out to debtors each month with the ledgers but he stated that he had no occasion to make such a check, having implicit confidence in Wadsworth. In conclusion the learned Judge stated that the loss was not in any event caused by the alleged negligence or incompetency of the defendant auditors but was solely caused by the implicit confidence and trust which the president of the plaintiff company placed in his co-director and his secretary-treasurer, Wadsworth, by his anxiety to save a few dollars on the costs of a regular audit, by his refusal to bond employees handling cash and by his refusal to authorize the auditors to notify the several debtors of the amounts appearing due.

NEW LEGISLATION RESPECTING TAXATION DOMINION AND PROVINCIAL

Editor's Note: The information published under this heading indicates only in general terms the nature of recent legislation of the Provincial Governments respecting Taxation. *For the Text of the legislation, readers should refer to the respective Acts.* As the Dominion Income Tax Act, for the sake of convenience, has been having frequent office consolidations, it has been decided to publish in this column, for reference purposes, the amendments in full each year. A copy of the Dominion Statute can be obtained from the King's Printer, Ottawa, and of a Provincial Statute from the King's Printer of the Province concerned.

To provide information to chartered accountants who are called upon by their clients to prepare taxation returns in other provinces, the Dominion Association of Chartered Accountants some time ago sent to the reference library of each provincial Institute a complete set of tax legislation passed by the various provincial legislatures, and is keeping this information up to date by sending copies of amendments to such legislation as soon as these amendments are available for distribution.

(Continued from August Issue)

IX. Quebec

Corporation Tax Act—Corporation Tax Act (Chapter 26, 1925) with subsequent amendments, has been repealed and replaced by *Corporation Tax Act* (Chapter 19, 1939).

Application—This Act provides for an annual tax on:

(a) Every incorporated company carrying on any undertaking, trade or business either in its own name or through any person paid by salary or commission or in any other manner acting as employee, vendor, agent, representative or othewise;

(b) All partnerships, associations, firms or persons whose main office or principal place of business is outside the Dominion of Canada and doing business in the Province of Quebec in his or its own name or under a firm name or through any person paid by salary or com-

mission or in any other manner acting as employee, vendor, agent, representative or otherwise;

(c) Banks, insurance companies, loan companies, navigation companies, telegraph companies, telephone companies, express companies, tramway companies, railway companies, sleeping, parlour and other car companies, trust companies, gas and electric companies, gasoline companies, real estate companies, liquor companies, brewery companies and tobacco companies, and

(d) Trustees in bankruptcy, assignees, liquidators or receivers who continue as such to carry on in the Province of Quebec the business of any corporation, partnership, firm or association above mentioned.

The basic of taxation is as follows:

(a) Incorporated companies referred to under (a) in the preceding paragraph—the tax is based on (1) paid-up capital; (2) profits, and (3) number of places of business.

The rates are as follows:

Paid-up capital—1/10th of 1%

Profits—2½%

Places of business—$50.00 for each place of business in Montreal and Quebec; $25.00 for each place of business elsewhere in the province. Where the amount of the paid-up capital of the company is under $25,000.00 the amount of the place of business tax is $25.00 for each place of business in Montreal and Quebec and $20.00 for each place of business elsewhere in the province.

(b) Partnerships, etc. referred to under (b) in the preceding paragraph—1/10th of 1% of gross earnings in the Province (minimum tax—$25.00); profits—2½%; places of business—$50.00 for each place of business in Montreal and Quebec and $25.00 for each place of business elsewhere in the province.

(c) Special companies referred to under (c) in the preceding paragraph—the tax is based on the amount of business done as measured in a variety of ways and/or the number and location of places of business. For particulars of rates and bases of taxation of such companies reference should be made to the Act. It should be noted that the profits tax applies to all special companies excepting banks, insurance companies, tramway companies, railway companies and trust companies.

(d) Trustees in bankruptcy, etc. as referred to under (d) in the preceding paragraph—rates and bases of taxation are as above dependent on the nature of the business carried on. It should be noted that any company whose head office is designated as being in Quebec which is entirely without assets and which, in the opinion of the Provincial treasurer, has not commenced or has ceased to do business and if it has not surrendered its charter is required to pay an annual tax of $20.00.

(e) Special cases—the Lieutenant-Governor in Council may fix at a sum less than the prescribed taxes the tax payable on capital of any company which (1) does part only of its business in the province; (2) does no business therein other than holding the stocks, bonds or other securities of other companies; (3) being a holding company and having its statutory office outside of Quebec has an office or holds directors' meetings in the Province or keeps in Quebec a bank account or part of the securities under its control; or (4) being a mining company is not, in the opinion of the treasurer, developing its properties and is not producing for the market.

(f) Holding companies—the Lieutenant-Governor in Council may fix at a sum less than that prescribed the tax payable on profits of any company doing no business in the province other than that of holding the stocks, bonds and other securities of other companies.

Definition of Paid-up Capital (when relating to an incorporated company)—Paid-up capital includes the paid-up capital stock of the incorporated company comprising ordinary and preferred stock, its surplus and reserve funds except any reserve for ordinary wear and tear, the creation of which is allowed as a charge against revenue under the Act, all indebtedness of the company whether assumed or undertaken by the company and represented by bonds, mortgages, debentures, income bonds, income debentures, liens, notes and any security to which the property of the company is subject, every other indebtedness of a capital nature and every other undivided interest or other participating interest in the nature of capital stock such as "units," "trustee shares," "trustee certificates" and the like provided that when goodwill is included as an asset a deduction may be allowed to the extent that such goodwill, in the opinion of the treasurer, has no value and provided also that when the balance sheet submitted to shareholders shows a deficit the amount of such deficit may be deducted from the amount of the paid-up capital.

Definition of Profits (when relating to an incorporated company)—Profits include the annual profits directly or indirectly made from any trade or industry or from any commercial, financial or other business; the interest, dividends and profits directly or indirectly received from money at interest with or without guarantee or from investments in securities or any other investment and also the annual profit or gain from any other source and rents, royalties and other like periodical receipts which depend on the production or use of any real property of a company notwithstanding that the same are payable on account of the use or sale of any such property. The profits as defined are subject to the following exemptions and deductions:

(a) Such reasonable amount as the Provincial treasurer may allow for depreciation, depletion, obsolescence or bad debts. However, in no case shall the amount deductible for depreciation, depletion, obsolescence or bad debts exceed the amount respectively set forth therefor in the financial statements submitted by the company to its shareholders.

(b) One-half of the dividends received from Canadian corporations where such corporations are taxable under the Act, and one-half of the dividends received from Canadian corporations having paid a tax on profits in the other provinces, provided that such provinces allow a similar exemption to companies in Quebec.

In computing profits no deduction is allowed in respect of,

(a) Disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purposes of earning revenue.

(b) Any outlay, loss or replacement of capital or any payment on account of capital;

(c) Amounts transferred or credited to a reserve, contingent account or sinking-fund, except such amount for bad debts, depreciation, depletion and obsolescence as the Provincial treasurer may allow;

(d) Carrying charges or expenses on an unproductive property or assets not acquired for the purposes of the trade, manufacture or business of the company; or a liability not incurred in connection with the trade, manufacture or business of the company;

(e) The whole or any portion of any salary, bonus, fees or commission which the Provincial treasurer may consider in his opinion in excess of what is reasonable for the service performed;

(f) The amount of tax upon revenue, paid or payable to the Dominion of Canada or to any other jurisdiction, including the Province of Quebec;

(g) The whole of any salary paid or payable to a person who is not an officer nor an employee of the company;

(h) The whole or any part of a commission which, in the opinion of the Provincial treasurer, is not earned;

(i) The whole or any part of a commission which is at a rate in excess of the one set forth in the contract passed between the company and its employee or agent.

Definition of Place of Business—The term "place of business" means the company's head office, offices, stores, factories, workshops, agencies, stations; the executive office of a company, any building or part of a building or any property where a company carries on any of its operations; any building, office in a building, room or location where a company invites patronage either through its name being placed in public view on the property, a listing of its name in the telephone directory or an advertisement in the press giving the name of the company and its address at such a location and any office, room or location situated in Quebec used by a company as its mailing address; any office or room of an agent of a company which agent accepts or takes orders or makes contracts for a company which is his principal; any permanent sample depot where a representative of a company may display samples of his company's products for sale; any depot where a representative of a company may buy materials for the use of his company and any depot for the distribution of goods.

Deduction from Tax on Profits Otherwise Payable—All corporations liable to the tax upon profits are entitled to deduct from the total of the tax which would otherwise be payable the amount of any tax upon profits payable to any other province, state or country for the same year according to the following rules:

(1) The quota of profits which shall be considered to have been made in such other province, state or country shall be proportionate to the percentage which the gross sales made or the gross revenue received in each such province, state or country bear to the total gross sales made or gross revenue received;

(2) No deduction shall be allowed unless the corporation furnish satisfactory evidence to the Treasurer of the amount of the said tax paid or payable for such same year to the government of such other province, state or country;

(3) No deduction shall be allowed with respect to the taxes paid to the Dominion of Canada on the net income of corporations.

The returns and payment of taxes are as follows: Returns are required annually within four months of the end of the fiscal year. Capital and place of business tax is payable in advance on May 1. Tax on profits is payable with return, i.e., within four months of the end of the fiscal year. Legal interest is payable on unpaid taxes from the date on which the tax is payable, and for failure to file return and pay amount of taxes as estimated by the company in the return on or before due date there is a penalty of 5% of the amount of the tax payable for the first month of default and 1% per month for each month thereafter.

X. Saskatchewan

The Corporations Taxation Act—The principal changes brought about by the 1939 amendments are summarized as follows:

Insurance Companies—Taxes payable are increased by one-half for all payments to be made in 1939; date for filing return and payment of tax is changed to 31st March; the minimum tax payable shall not be less than that payable if assessed as an ordinary company.

Finance Companies—A minimum tax of $100 ($175 where authorized capital exceeds $100,000) is established subject to the provision that the tax payable shall in no event be less than would be payable if assessed as an ordinary company. The date for filing return and

payment of tax changed to 1st March and monthly returns are no longer required.

Loan Companies and Trust Companies—The minimum tax payable shall not be less than that payable if assessed as an ordinary company. The date for filing return and payment of tax is changed to 1st March.

All Other Companies—The date for filing return and payment of tax is changed to 1st March.

General—The charging section of the Act has been amended to include companies transacting business in the Province through an agent. Numerous other changes have been made, the most important of which deal with,—

(a) The commencing or ceasing of business in the Province;
(b) Definitions of certain of the types of companies liable to taxation under special sections of the Act;
(c) Interest on unpaid taxes, penalties;
(d) Collection of taxes and other administrative matters.

Individuals, partnerships and unincorporated syndicates and trusts are specifically made exempt from the tax on ordinary companies. Certain of the changes came into force on the date of assent (1st April) while others take effect on other dates.

The Income Tax Act, 1936—The more important changes brought about by the 1939 amendments are as follows:

The charging section of this Act which formerly closely resembled Section 9 of the Dominion *Income War Tax Act* has been completely changed. The new section renders taxable the income of persons resident in the Province and the income earned in the Province by non-resident persons. (Under the Act, "persons" includes corporations).

In special circumstances the tax payable is at the rate of 2% of gross income within the Province. This applies to non-resident persons entering the Province temporarily and may also apply to other non-residents and to corporations trading with affiliates at other than fair market prices.

The income of certain types of companies taxed under special sections of *The Corporations Taxation Act* (banks, insurance companies, etc.) is exempt from taxation under *The Income Tax Act, 1936.*

A deduction from tax of the amount paid under *The Corporations Taxation Act* was formerly allowed all companies. This deduction has been abolished.

The definition of income has been changed to specifically include rents, royalties and annuities. The circumstances in which allowance will be made for dependents are somewhat restricted. Certain additional items have been added to the class of expenses not deductible from income (excessive salaries of directors or officers, losses of extra-provincial branches and in some cases contributions to pension funds by employers or employees).

The time for making returns may now only be extended when a request has been made before the usual date for filing.

GENERAL NOTES

Annual Meeting of Association

On the day the September issue of THE CANADIAN CHARTERED ACCOUNTANT went to press, the thirty-seventh annual meeting of The Dominion Association of Chartered Accountants was in progress. A report of that meeting will be published in the October issue.

Our Contributors This Month

GEORGE R. G. BAKER who writes on Canada's new central mortgage bank this month is well-known to our readers as the contributor of several articles. He is a graduate of the University of Toronto and of Osgoode Hall. He engaged in the general practice of law until March 1936 when he was appointed to the positions he now holds as Secretary-Treasurer of The Land Mortgage Companies' Association of Ontario and a member of the staff of The Dominion Mortgage and Investments Association.

W. NORMAN BUBB whose address "The Accountant and the Community" was delivered at a recent conference of the Society of Incorporated Accountants and Auditors (England), is a Fellow of that Society and a member of its Council. He is a partner in the firm of Woodington, Bubb and Company, incorporated accountants, London.

EDWARD F. JEAL whose article "The Learned Judges and the Auditor" is reprinted from *The Accountant* in this issue holds the degrees of B.Sc. (Econ.) and B.Com. and became an associate member of The Institute of Chartered Accountants in England and Wales in 1925. He is in the Paris office of Deloitte, Plender, Griffiths and Company.

JOHN L. MCDOUGALL a previous contributor to THE CANADIAN CHARTERED ACCOUNTANT has written this month on "Consumption Standards and the Housing Problem." He is a graduate of the University of Toronto (M.A. 1923) and has pursued post-graduate studies at the London School of Economics (1923-24) and at Harvard University (1924-25). In 1925-26 he was instructor at the University of Texas and during the next year was lecturer at the University of Toronto. For the next four years he was Statistician with Canadian General Securities, Limited and in 1932 was appointed Professor of Commerce at Queen's University, which position he now holds.

Public Administrations Seeing Need of Efficient Accounting Methods

All who have read the recent newspaper report of the unfortunate condition of the accounts of the City of Charlottetown will realize the importance of an efficient audit annually. In addition to having such audit, a municipality should give thought to the adoption of modern systems of accounting. The following editorial, which has a practical lesson for all municipal councils on this continent, appeared in "The Boston Herald" on 28th July last, and we take the opportunity of publishing it in these columns.

> Shortly before sailing for Europe last week, Mayor Tobin announced that he had enlisted the voluntary aid of a group of public accountants in an effort to improve accounting methods and office procedures in city departments. The committee, of which Charles F. Rittenhouse is chairman, includes about twenty of the leading public accountants in Boston. It will work in co-operation with the municipal survey committee and its director, Leo T. Foster.
>
> That there is a radical need for the services of such a group, no one who has ever done business with City Hall can doubt. Particularly in the assessing, welfare and hospital departments, where an enormous amount of paper work is done annually, more efficient methods of handling accounts and keeping records could unquestionably be installed. The advice of a group of expert accountants, who are familiar with modern bookkeeping techniques in use here and throughout the country, will be extremely helpful in this direction. The city government is the largest single enterprise in Boston. There is no really valid reason why its administrative methods should not be the most modern and efficient.
>
> As for the committee, its services to the city can be just about as valuable as its members care to make them. If they choose to perform them in a perfunctory manner, the results will probably be perfunctory. If, however, they are willing to take their coats off and work with city officials in an intensive study of their problems, the results may be far reaching.

Canada's 1938 Tourist Trade

In the June 1939 issue of *The National Revenue Review*, a publication of the Department of National Revenue, Ottawa, is presented an estimate of the value of the Canadian tourist trade for the calendar year 1938.

The expenditures of visitors to Canada during that year are estimated at approximately $273.4 millions, the bulk of which, 94.7 per cent., is accounted for by the spending of over 17 million persons from the United States. The total value of the tourist trade declined about $17 millions from 1937 with a proportionate decrease in the expenditures of visitors from the United States.

The heaviest spenders were motorists whose outlays amounted to approximately $180.2 millions, while tourists entering by train, boat and other facilities accounted for the balance.

* * *

It is interesting to note that Canadian tourists spent about $123.9 millions a decrease of approximately $500,000 from 1937. About 83 per cent. of this amount was spent among our neighbours to the south and most of the balance went to overseas countries.

Institute of Chartered Accountants in England and Wales

The results of the examinations of the Institute held in May 1939 show that 252 were successful in the final examination out of a total of 516 writing; in the intermediate 257 out of 505, and in the preliminary 59 out of 252.

The approximate percentages of passes were: Final 49%, intermediate 51% and preliminary 23%.

The Society of Incorporated Accountants and Auditors

The results of the May 1939 examinations of the Society are summarized as follows: In the final examination, 162 candidates out of a total of 366 were successful; in the intermediate 157 passed out of 374 writing, and in the preliminary 99 out of 184.

The approximate percentages of passes were: Final 44%, intermediate 42% and preliminary 55%.

PERSONALS

Mr. R. C. Bertram, B.Com., chartered accountant, wishes to announce the opening of an office for the practice of his profession at 443-4 Confederation Life Building, Toronto.

Messrs. Morrell and Company, chartered accountants, announce the opening of an office in the Eastern Trust Building, Charlottetown, P.E.I., under the personal direction of Mr. B. M. Sears, C.A., as resident partner.

LEGAL DECISIONS

[EDITOR'S NOTE: The following are brief summaries of recent decisions of the Canadian Courts as taken, by the kind permission of the Canada Law Book Company, from the *Dominion Law Reports*. In each case reference is made to the volume of the *Reports* where the full judgment may be found. It should be kept in mind that the decisions given may not in every case be final.]

Companies—Fiduciary position of promoter—Secret profits—Liability to account

(Proprietary Mines Ltd. v. *MacKay)*

Ontario Court of Appeal

Upon the bankruptcy of a mining company of which defendant was in exclusive control he filed a proof of claim as an ordinary creditor for $180,000 which to his knowledge was almost wholly invalid. Having then in contemplation the incorporation of plaintiff company to acquire the bankrupt company's assets, defendant organized a Syndicate which concluded an agreement with the trustee in bankruptcy—who had not passed on defendant's claim—to purchase the bankrupt company's assets on payment of the various claims, defendant reserving the right to refuse payment of any claim. Plaintiff company on incorporation, defendant being in sole control through a dummy directorate, assumed the purchase agreement, and defendant assigned to it his claim against the bankrupt company, taking in exchange 180,000 shares of $1 par value in plaintiff company. The company subsequently assigned defendant's claim to the trustee in part payment of the assets of the bankrupt company, and the trustee was discharged. In an action for rescission and damages, held: In failing to disclose the true nature of his claim to an independent directorate defendant was guilty of a constructive fraud, thereby committing a breach of his duty as a promoter standing in a fiduciary position towards the company. While rescission could not be ordered owing to the impossibility of *restitutio in integrum*, the defendant's claim having been assigned to the now discharged trustee, no rescission was necessary. To the extent that he had obtained shares in excess of the actual value of his claim defendant had misappropriated them and such shares if not sold to innocent purchasers for value must be delivered up for cancellation; as to shares sold to innocent purchasers for value, defendant was liable to account to the company by way of compensa-

tion, indemnity or damages. The fact that the trustee had not disallowed defendant's claim did not in the circumstances prevent the Court from investigating its validity. Henderson J.A. dissented mainly on the grounds that there was no fraud, no evidence of secret profits, that defendant did not stand in a fiduciary capacity towards the company when he became a creditor of the bankrupt company, plaintiff company, not then being in his contemplation, and that plaintiff company could not attack the validity of defendant's claim after accepting it and assigning it to the trustee without question.—[1939] 3 D.L.R. 215.

(Note: A previous reference to the judgment of the Ontario Supreme Court was made at p. 56 of the January 1939 issue of THE CANADIAN CHARTERED ACCOUNTANT.)

Taxes—Business assessment—Local sales office of outside factory

(Toronto v. *Belding-Corticelli Ltd.)*

Ontario Court of Appeal

The Toronto office of a company which manufactures goods in Quebec, maintained solely for purposes of taking orders and storing the factory's produce until sold, is assessable under s. 8(1)(e) of the Assessment Act, R.S.O. 1937, c. 337 as part of the business of a manufacturer and not under s. 8(1)(c) as part of the business of a wholesale merchant.—[1939] 3 D.L.R. 73.

TERMINOLOGY DEPARTMENT

Note: The series of terms and definitions in the Terminology Department will be resumed in the November issue.

STOCK BROKERS' ACCOUNTS

Theory and Practice

This series of discussions on the subject of stock brokerage accounting theory and practice has been prepared by a group of members of the profession familiar with the subject. They desire to have it understood that the definitions, opinions and observations appearing in this column are their own and are not necessarily those of the Dominion Association.

(Continued from August issue)

"Puts" and "Calls"

Their Definition and Application

"Puts" and "Calls" are options (sometimes called privileges) in which the taker of a sum of money, called a premium, cedes to the giver of the premium the privilege to demand within a specified time, and at a predetermined price, the completion of a purchase or sales contract.

The holder of a put has the privilege of selling to the giver of the put, on or before a fixed date, shares of stock on which the number of shares and price have been agreed upon.

A call entitles the holder thereof to buy at his election, on or before a fixed date, a specified number of shares of stock at an agreed price from the seller of the call.

The purchaser of a put or call privilege is not under obligation to exercise his option whereas the seller must fulfil his contract if called upon to do so within the specified time.

The New York put and call options are usually given for thirty (30) days and the premium paid is a fixed sum per 100 shares of stock regardless of the value of the stock involved. Options cost the purchaser $300.00 per 100 shares when bought at the prevailing market price and $137.50 per 100 shares when purchased at a price which is a specified number of points above or below the prevailing market price.

Put and call privileges are used in lieu of stop loss orders as insurance, and are also used in preference to taking long or short positions in the market. The value of a stop loss order is often lost in a fast changing market when the order cannot be filled near the price stipulated in the order. When put and call options are used, the holder's loss is limited to the price stated for the time covered by the option. The put and call may be used as insurance against substantial losses when a holder of stock or one with a short position

does not wish to sell or cover. In this case puts or calls are purchased and used if the market fluctuates beyond the prices specified in the options.

A trader anticipating a fall or rise in certain stocks could purchase this form of option in lieu of taking an actual position in the market. Should the market price of the stock named in the option not react as anticipated, the purchaser of the option then would not exercise his privilege. But should the market price of the stock rise or fall sufficiently to give the holder of the option a profit, then the privilege would be exercised. In applying the uses of puts and calls, it must be remembered that they cover only the period set forth therein, and the extent of the profits derived therefrom depend upon the time chosen by the holder to exercise his privilege.

For example, let it be assumed that two parties A and B purchase 30-day put options for different purposes. In one case A was holding 100 U.S. Steel purchased at $60.00 and expected a fall in the market price but did not want to sell, and in the second case B anticipated a decline but did not wish to go short. The market price of U.S. Steel at the time the puts were purchased was $60.00 but the price quoted in the put was $55.00, five points below the prevailing market price of $60.00. For the purpose of this example we will assume that the options were exercised on the last day when the market price of U.S. Steel had declined to $45.00 per share. Naturally, both A and B would exercise their privileges and thus A would have saved $10.00 a share on 100 shares and B would buy in 100 shares at $45.00 per share and deliver same for $55.00 per share thus making a profit of $10.00 per share. In both these cases for the cost of $137.50, A saved $1,000.00 and B made a profit of $1,000.00. Of course the above figures are subject to tax and commission which is paid by the holder of the option. If the market value of U.S. Steel had not gone down more than five points, there would not have been any point in A and B exercising their options; thus they would have lost the cost of the privilege.

The call is applied when a rising market price is anticipated but the procedure is the same as applied in the put except that the price quoted is above the prevailing price when the option is sold.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

Joint venture accounting or accounting for the transactions of informal partnerships presents a simple but none the less interesting problem which appears less frequently on examination papers in this country than in those in England or Scotland. It may be that commercial ventures of this kind are less common here but all of us at some time or another are engaged in financial, if not commercial, operations whose settlement necessitates application of the joint venture technique. Two friends agree to dine and visit the theatre together; one pays for the dinner and the taxies, the other for the theatre tickets and sundries: Or four men decide on a joint motor tour to the World's Fairs; one provides the car, all pay expenses indiscriminately as convenience dictates. The problem in each case is the settlement—and the reason why formal double entry accounting is rarely employed in its solution, even though one of the joint adventurers be an enthusiastic accountant, is that the solution is reached so much more simply by a few informal arithmetical calculations on scraps of paper. It is good fun however (and an exercise not to be despised) to raise a set of double entry accounts for this purpose. But our own experience suggests the desirability of rehearsing in private before embarking on a public exposition of even so simple a problem as this: A and B agree to go on a holiday together and to share the cost equally. A provides the automobile and is to be allowed 2¼ cents per mile for depreciation. A pays holiday expenses totalling $217.49 and lends B $25 for some personal purchases. B pays holiday expenses totalling $97.27. The holiday mileage was 4,000. It would have been only 3,800 if B had not lost his way while driving.

* * *

The total of municipal financial losses resulting from laxity in the appointment of municipal officers and auditors continues to mount. Recently the former tax collector for two rural municipalities in eastern Ontario was sentenced to four years' imprisonment for misappropriation of funds

of one of these municipalities and to three years' imprisonment for misappropriation of funds of the other. The magistrate in passing sentence observed that the municipalities had been lax in the handling of their affairs but that this did not excuse the collector's misconduct. A criminal conviction in cases such as this can be but cold comfort to taxpapers who have, in effect, to make up the amount of the defalcation in taxes and also to contribute in taxes towards the support of one more individual in our penal institutions. And yet losses of this kind can be expected to continue until taxpayers realize that they have to shoulder not only the financial burden but also the very heavy moral responsibility for the human wreckage.

* * *

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by a practising chartered accountant of the Institute from whose examinations the problem is taken and represent his views and opinions. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

THE SOCIETY OF CHARTERED ACCOUNTANTS OF THE PROVINCE OF QUEBEC

FINAL EXAMINATIONS, OCTOBER, 1938

ACCOUNTING "B"

Question 1

Company A, whose paid-up capital stock is $750,000.00, directly or indirectly controls or has an interest in three other companies. These companies are B, C and D, whose paid-up capital stocks are respectively; B—$400,000.00; C—$300,000.00; D—$250,000.00.

The inter-company holdings at December 31, 1937, were as follows, the shares having been acquired at the dates shown and for the prices stated:

	Interest acquired	Date acquired	Price paid
Coy. A Holdings:			
Coy. B Stock	75%	Dec. 31, 1934	$460,000
" "	10%	Dec. 31, 1935	65,000
" "	10%	Dec. 31, 1936	70,000
Coy. C Stock	25%	Dec. 31, 1934	105,000
Coy. D Stock	10%	Dec. 31, 1934	36,000
" "	20%	Dec. 31, 1935	72,000
Coy. B Holdings:			
Coy. C Stock	40%	Dec. 31, 1934	165,000
" "	20%	Dec. 31, 1935	85,000
Coy. C Holdings:			
Coy. D Stock	10%	Dec. 31, 1934	35,000

The profit and loss accounts of the various companies for the three years ended December 31, 1937, were as follows:

	A	B	C	D
Balance, Dec. 31, 1934 ..	315,000	180,000	112,000	84,000
Profit for 1935	135,000	72,000	28,000	15,000
Profit (or Loss) for 1936..	148,000-P	65,000-P	4,000-L	2,000-P
Profit for 1937	154,000	57,000	10,000	8,000
	$752,000	$374,000	$146,000	$109,000
Dividends Paid:				
Year 1935	150,000	60,000	24,000	12,500
Year 1936	150,000	60,000		5,000
Year 1937	150,000	60,000	6,000	5,000
	450,000	180,000	30,000	22,500
Balance, Dec. 31, 1937	$302,000	$194,000	$116,000	$86,500

Investments are carried at cost, and the profits as shown above include dividends received.

You are required to determine the following, which would appear in a Consolidated Balance Sheet of A Company and Subsidiaries at December 31, 1937:

(a) Goodwill arising from purchase of Subsidiary Companies' stock.

(b) Minority Interests, by schedule.

(c) Consolidated Surplus, showing balance brought forward January 1, 1937, profit for year, dividend paid, and closing balance.

SOLUTION

As the proportion of the stock of Company D held directly or indirectly by the Parent Company is less than 50%, Company D does not come within the definition of a subsidiary company, and consequently its accounts should not be consolidated with those of the other companies.

Profits of Companies excluding dividends from Subsidiary Companies:

Company A	*1935*	*1936*	*1937*
Profit per Profit & Loss Account	$135,000	$148,000	$154,000
Less: Dividends from Subsidiary Companies			
Company B—75%; 85%; 95%	45,000	51,000	57,000
Company C—25%; 25%; 25%	6,000	—	1,500
	51,000	51,000	58,500
Profits before dividends	$ 84,000	$ 97,000	$ 95,500
Company B			
Profit per Profit & Loss Account	$ 72,000	$ 65,000	$ 57,000
Less: Dividends from Subsidiary Company			
Company C—40%; 60%; 60%	9,600	—	3,600
Profits before dividends	$ 62,400	$ 65,000	$ 53,400

Computation of profits of Companies, including proportion of profit of Subsidiary Companies:

	A	*B*	*C*
Year 1935:			
Profit before dividends	$ 84,000	$ 62,400	$ 28,000
40% of C		11,200	
75% of B	55,200	$ 73,600	
25% of C	7,000		
	$146,200		
Year 1936:			
Profit (or loss) before dividends	$ 97,000	$ 65,000	$ 4,000L
60% of C		2,400L	
85% of B	53,210	$ 62,600	
25% of C	1,000L		
	$149,210		
Year 1937:			
Profit before dividends	$ 95,500	$ 53,400	$ 10,000
60% of C		6,000	
95% of B	56,430	$ 59,400	
25% of C	2,500		
	$154,430		

ADJUSTED SURPLUS ACCOUNTS:

	Company A	*Company B*	*Company C*
Balance—December 31, 1934	$315,000	$180,000	$112,000
Profit for 1935	146,200	73,600	28,000
	461,200	253,600	140,000
Less: Dividends	150,000	60,000	24,000
Balance, December 31, 1935	311,200	193,600	116,000
Profit (or loss) for 1936	149,210	62,600	4,000L
	460,410	256,200	112,000
Less: Dividends	150,000	60,000	

Balance, December 31, 1936	310,410	196,200	112,000
Profit for 1937	154,430	59,400	10,000
	464,840	255,600	122,000
Less: Dividends	150,000	60,000	6,000
Balance, December 31, 1937	$314,840	$195,600	$116,000

Computation of Goodwill:

Company A:

Company	Date acquired	Net Worth of Company	%	Acquired Amount	Price paid	Goodwill
B	December 31, 1934	$580,000	75	$435,000	$460,000	$ 25,000
B	December 31, 1935	593,600	10	59,360	65,000	5,640
B	December, 31, 1936	596,200	10	59,620	70,000	10,380
C	December 31, 1934	412,000	25	103,000	105,000	2,000
						$ 43,020

Company B:

C	December 31, 1934	412,000	40	164,800	165,000	200
C	December 31, 1935	416,000	20	83,200	85,000	1,800
						$ 2,000
TOTAL						$ 45,020

ANSWERS:

(a) Goodwill—$45,020.00.

(b) Minority Interests, by schedule:

	Capital Stock	Surplus	Total	%	Amount
Company B	$400,000	$195,600	$595,600	5	$ 29,780
Company C	300,000	116,000	416,000	15	62,400
					$ 92,180

(c) Consolidated Surplus:

Balance, January 1, 1937		$310,410
Profit for Year 1937:		
Company A	$ 95,500	
25% of Company C	2,500	
95% of Company B	56,430	154,430
		464,840
Less: Dividend paid		150,000
Consolidated Surplus, Dec. 31, 1937		$314,840

PROBLEM II

THE SOCIETY OF CHARTERED ACCOUNTANTS OF THE PROVINCE OF QUEBEC

FINAL EXAMINATIONS, OCTOBER, 1938

ACCOUNTING "B"

Question 4

Peter Sharp, formerly residing in Montreal, died April 1, 1937,

leaving a Will which appointed two executors, and provided for the following bequests:

X—4/11, B—2/11, C—5/11 share of the entire estate after payment of funeral expenses, debts, etc. and a specific bequest of $10,000.00 to the A Hospital (free of Succession Duty). The Will directed that the income of the estate for the period of one year from the testator's death should also be paid to the A Hospital, and that the executors should then prepare an account of their administration, preparatory to the division of the remaining assets among the residuary legatees. The executors' remuneration was fixed by the Will at $3,500.00.

The inventory filed by the Executors listed assets as follows: 5% First Mortgage for $45,000.00, interest payable semi-annually on June 30 and Dec. 31; 500 shares of Bartlett Co. common stock, par value $100 market value $110; $5,000 5% 1st Mtge. Bonds of South-Western Rly., interest payable semi-annually on March 1 and Sept. 1, market value 103 per $100 bond; accounts receivable, $18,600.00; cash in banks and on hand, $68,146.00; household furniture and personal effects appraised at $5,750.00.

The Executors' transactions were as follows:

CASH RECEIPTS

2% dividend on Bartlett Co. stock, declared March 20, 1937, and paid April 15, 1937.

2% dividend on Bartlett Co. stock, paid July 15, 1937.

500 shares Bartlett Co. stock sold July 31, 1937 @ $114 per share.

$4,000 Railway Co. bonds sold July 1, 1937 at $106 per $100 bond, and accrued interest.

Accounts collected, $17,850.00 (balance worthless).

Interest on bank balances $1,150.00, of which $210.00 accrued prior to death of testator.

Interest on bonds and mortgage collected on due dates.

CASH PAYMENTS

Funeral Expenses and expenses of last illness	$ 1,800
Expense of probating Will and legal expense re Inventory	335
Succession Duties, $12,100. Interest thereon $75	12,175
Stationery, postage and general expense	116
Debts of Deceased paid	10,760
X on account of Legacy	10,000
C on account of Legacy	20,000
Executors' remuneration — on account	2,500

The furniture and effects were taken by X at the appraised valuation. Interest on advances to March 31, 1938 amounts to X—$260; C—$310. Accrued bank interest to March 31, 1938—$275.

PREPARE:

(a) Summary Statement April 1, 1938, separating principal and income. (Assume payment of balance of Executors' remuneration, legacy to A Hospital, and income of Estate for year to A Hospital).

(b) Statement showing amounts due Beneficiaries.

SOLUTION

Summary Statement of Executors' Account
Estate of Peter Sharp
from APRIL 1, 1937 to APRIL 1, 1938.

AS TO PRINCIPAL:		
We charge ourselves as follows:		
With the assets of the Estate at date of death April 1, 1937 as per Inventory, Schedule A	$199,439.33	
With increases of assets realized through sales, Schedule B	2,120.00	$201,559.33
We credit ourselves as follows:		
With amount paid for funeral and administrative expenses, Schedule C	5,635.00	
With amount of Succession Duties paid	12,100.00	
With amount of debts of deceased, paid	10,760.00	
With amount of decrease in assets, due to accounts proving uncollectible	750.00	
With amount of Specific Legacy paid to A Hospital	10,000.00	
With amounts paid or delivered to General Legatees, Schedule D	36,320.00	75,565.00
Leaving a balance of Principal of (Schedule E)		$125,994.33
AS TO INCOME:		
We charge ourselves as follows:		
With amount of income received, Schedule F	3,723.33	
With amount of income accrued at April 1, 1938, Schedule G	1,411.67	5,135.00
We credit ourselves as follows:		
With amount of expenses paid, Schedule H	191.00	
With amount paid to A Hospital, being net income for the year	4,944.00	5,135.00
No balance		
SCHEDULE A—Inventory of Assets at date of death, April 1, 1937		
Mortgage:		
First mortgage, interest @ 5%, payable June 30 and December 31 — principal amount	$45,000.00	
Accrued interest, Jan. 1 to Apr. 1, 1937	562,50	45,562.50
Bonds:		
South-Western Railway, First Mortgage, 5% interest payable March 1 and September 1, face value $5,000 and having a market value of $103 per $100 bond	5,150.00	
Accrued interest, March 1 to April 1, 1937	20.83	5,170.83
Shares, and dividend declared prior to date of death:		
Bartlett Co. Common stock, 500 shares, market value $110 per share	55,000.00	
Dividend	1,000.00	56,000.00

Other Assets:

Cash in bank and on hand	68,146.00	
Accrued interest on bank balance	210.00	68,356.00
Accounts receivable		18,600.00
Household furniture and personal effects		5,750.00
		$199,439.33

SCHEDULE B—Increases realized through sales:

	Amount Received	*Value per Inventory*	*Increase*
500 shares Bartlett Co. Common	$57,000	$55,000	$2,000
$4,000 South-Western Railway Co. Bonds	4,240	4,120	120
			$2,120

SCHEDULE C—Funeral and Administrative Expenses:

Funeral expenses and expenses of last illness	$1,800.00
Probating will and legal expenses re inventory	335.00
Executors' remuneration, as fixed by the will	3,500.00
	$5,635.00

SCHEDULE D—Amounts paid or delivered to General Legatees:

Distribution to X of the following:		
Household furniture and personal effects	$ 5,750.00	
Cash advance	10,000.00	
Interest on advance to March 31, 1938	260.00	16,010.00
Distribution to C of the following:		
Cash advance	20,000.00	
Interest thereon to March 31, 1938	310.00	20,310.00
		$36,320.00

SCHEDULE E—Assets of the Estate in our hands, April 1, 1938:

Firt Mortgage, 5%—principal amount	$45,000.00	
Accrued interest, January 1 to April 1, 1938	562.50	$45,562.50
$1,000 South-Western Railway 5% Bond	1,030.00	
Accrued interest, March 1 to April 1, 1938	4.17	1,034.17
Cash in bank	79,122.66	
Accrued interest on bank balance	275.00	79,397.66
		$125,994.33

SCHEDULE F—Income collected:

1937		
June 30	Interest on mortgage—April 1 to June 30	$ 562.50
July 15	Dividend, Bartlett Co.	1,000.00
July 1	Interest on $4,000 South-Western Railway bonds sold, April, 1937 to July 1, 1937	50.00

Sept. 1	Interest on $1,000 South-Western Railway bond, April, 1937 to September 1, 1937	20.83
	Interest on bank account from April 1, 1937	940.00
Dec. 31	Interest on mortgage—July 1 to December 31 1938	1,125.00
Mar. 1	Interest on $1,000 South-Western Railway bond, September 1, 1937 to March 1, 1938 ..	25.00
		$3,723.33

SCHEDULE G—Income accrued as at April 1, 1938:

Interest on mortgage, $45,000 @ 5% from January 1 to April 1, 1938		$ 562.50
Interest on South-Western Railway bond, $1,000 @ 5% from March 1 to April 1, 1938		4.17
Interest on bank balance to March 31, 1938		275.00
Interest on advances to General Legatees:		
X	$260.00	
C	310.00	570.00
		$1,411.67

SCHEDULE H—Expenses paid applicable to Income:

Interest on succession duties	$ 75.00
Stationery, postage and general expense	116.00
	$191.00

NOTE: the item "stationery, postage and general expense" might be charged to Capital Account, or be apportioned.

CASH ACCOUNT—to support cash balance shown in Schedule E:

Balance, April 1, 1937		$68,146.00
Accrued interest, and dividend declared, April 1 collected (Schedule A)		1,793.33
Accounts receivable collected		17,850.00
Proceeds of sales (Schedule B)		61,240.00
Income collected (Schedule F)		3,723.33
		152,752.66
Funeral and administrative expenses (Schedule C)	$ 5,635.00	
Succession duties	12,100.00	
Income paid	5,135.00	
Debts paid	10,760.00	
Legacy paid	10,000.00	
Cash distributions to General Legatees ..	30,000.00	73,630.00
Balance, April 1, 1938		$79,122.66

(b) *Statement showing amounts due to Beneficiaries*

Total		*X*	*B*	*C*
$199,439.33	Assets, per inventory			
2,120.00	Increases through sales			
$201,559.33				

	Less:			
750.00	Asset unrealizable			
5,635.00	Funeral & administrative expenses			
12,100.00	Succession duties			
10,760.00	Debts of deceased			
10,000.00	Specific legacy			
39,245.00				
		4/11	2/11	5/11
$162,314.33	Amount divisible among General Legatees	$59,023.39	$29,511.70	$73,779.24
36,320.00	Less: Advances	16,010.00		20,310.00
$125,994.33	*Amounts due*	$43,013.39	$29,511.70	$53,469.24

DISCUSSION OF SOLUTIONS

Students' Department, July 1939, Problem II.

A reader writes: "I find an error in calculating the collectible amount from Company Y for Furniture and Fixtures. I obtain this:

$$\frac{90}{168} \text{ of } \$16{,}000 = \$8{,}571.43."$$

The practitioner comments as follows on the point raised: "If property is insured with several companies, each company assumes a liability for only a pro-rata portion of the loss; this portion is computed by multiplying the loss by a fraction, the numerator of which is the face of the policy, and the denominator of which is:

(1) The face of all policies, if the company's policy carries no co-insurance clause or if the insurance carried meets the requirements of the policy; (This is the situation in the case in question.)

(2) The insurance required under the co-insurance clause, if the company's policy contains such a clause and its requirements have not been met."